All aboard – the unit pricing journey

By Anthony Bathurst  Head of Unit Pricing, JPMorgan Worldwide Securities Services

INTRODUCTION

Why is unit pricing such a hot topic?
The area of unit pricing was once perceived as a backroom activity that flowed along steadily and attracted only modest interest from the financial services industry. In recent years unit pricing has attracted greater attention for initially all the wrong reasons. As the cracks began to widen the industry was reminded that this was not an area that neither product providers nor regulators could choose to ignore.

As the industry was confronted with damaging headlines over unit pricing errors, the costs of rectification soon became apparent and extraordinarily significant. The task of quantifying costs in the instance of a unit pricing error is extremely difficult. Not only is the process of deriving financial compensation a tedious exercise, the reputational damage is immeasurable and may far exceed the price paid to investors in dollars and cents.

While the discovery of errors within unit pricing had brought about an abrupt reactionary response, the element of time has allowed the industry to digest this information and move forward. Hence the news is not all bad.

Aside from the financial and reputational risks there is also the regulatory risk that must be addressed. The increase and size of unit pricing errors resulted in ASIC and APRA paying much closer attention. This ‘increase in attention’ resulted in a thorough review of the unit pricing function and the subsequent release of the ASIC/APRA Guide to Good Practice.

The unit pricing process should not be overly complicated. However in recent years we have been part of a journey that has scrutinised each component of the unit pricing function in an effort to better understand its mechanics and the challenges organisations face in an effort to ensure their practice is in the best interests of investors and meets regulatory requirements.

The scope of this paper reflects on some of these challenges and looks into some of the key topic areas being presently discussed within the industry. Although certain elements of unit pricing have been difficult to address, the increased importance and awareness of the function within the industry will certainly pay dividends as time progresses.
EVOLUTION OF UNIT PRICING

The recent past has seen the investment management industry enjoy a period of sustained growth through significant inflows and strong investment markets. A vast proportion of funds that have filtered through to fund managers have arrived by way of the superannuation industry. To illustrate this, the Australian retirement, pension or superannuation vehicle has grown to become the largest in Asia and the fourth largest in the world after that of the US, Luxembourg and France.

So how has the Australian market accommodated and fostered this growth? Firstly it is important to recognise that the marketplace is now home to increasingly sophisticated investors who appear to be both more aware and interested in where their once ‘idle cash’ or nest egg is invested.

While the market has been flooded with an upsurge in investor confidence evidenced through increased investment, it is the fund managers who have had to manage the challenge of being able to produce sustainable alpha in a market of capacity constrained asset classes. This issue is one that larger fund managers have experienced whereby their sheer fund size and associated transactions effectively drive the market and erode possible value that is attributable to the particular investment decision.

One method of dealing with this “capacity” headache by fund managers has been to limit or close investment options available to investors. However with increasing capital flows and heightened investor interest in investment decisions and associated returns, is this a viable solution? In many instances, the answer is probably not.

Alternatively, both domestic and international markets have seen the emergence of a suite of new and innovative products. These products have targeted the once ‘non-vanilla’ asset classes that include a diverse range of private equity and hedge fund offerings, infrastructure assets and a number of new property vehicles.

Applicable to every investment decision is the element of risk that must be addressed. As we have seen the industry’s growth drive new and innovative products as a means of attaining the increasingly elusive alpha along with meeting investors demands, is there an added element of risk within the industry as a result of investors not understanding these products and thus the risks contained within? This is something that we will discuss further at a later stage in the paper while analysing the scheme operator and service provider relationship.

Another key change in the Australian marketplace has been the increase in size of superannuation funds as a result of mergers and trustee licensing. In addition to this the creation of investor choice between funds has certainly had a significant impact on the superannuation industry. Whether or not it is a direct result of choice or general progression within investment markets, the superannuation product options are more innovative and provide a broader reflection of what is available in the market for investors with various risk/return appetites.

While funds managers have tended to drive the development of services relating to the increased speed or quality, such as daily unit pricing and the capability to handle abstruse instruments and long/short portfolios, the gap between their demands and those of the larger super funds has narrowed. Adding to the evolving nature of superannuation products has been the sustained period of out-performance, along with growth in media coverage and awareness, leading to a huge impact on the flow between funds.

Competition between market players is perhaps stronger than ever before, with industry funds and retail funds fighting for their share of the market.

Unit pricing has been a key and hotly debated topic within both the funds management and superannuation arena in the recent past. Although there have been large compensatable errors within the industry throughout the past decade, the prominence of managed funds has increased considerably.

As such there has been increased focus placed on unit pricing in a number of areas. Some of these include:

- Frequency of unit pricing.
- Availability of unit prices.
- Valuation methodology (unit price versus crediting rate).
- Forward versus historic unit pricing
- Robustness of processes and systems used to calculate and verify unit prices.
- Risk framework.

One of the most transparent changes to unit pricing over the past decade has been the frequency at which valuations are conducted. While many superannuation funds still value their funds on a monthly basis using either a crediting rate or unit price technique, many have transitioned to a weekly or daily valuation environment. In many instances this has been due to the need to reduce arbitrage opportunities (often a consequence of historic pricing) and to also facilitate active management and satisfy investor activity within more sophisticated and complex product offerings.

Although there is no single or defined manner in regards to how frequent a scheme operator should price its funds, there are a number of considerations that must be made when substantiating the valuation methodology. When determining the pricing frequency scheme operators need to take into account the complexity of information, liquidity of investments and the frequency with which unit holders can apply for and redeem units.

Associated with the trend to value unitised or crediting rate vehicles on more frequent basis, is the need to place a greater emphasis on operational areas within and outside a business to provide and analyse information in a more efficient manner. As such we have seen a greater reliance on technology solutions to facilitate the transfer and processing of this information to allow for the unit pricing function to capture all available data.

As we have seen the demands for unit price availability increase and with the expectation that many scheme operators may continue to move towards a daily/weekly unit pricing environment, it is imperative that the appropriate risk and control framework is maintained in order to protect against reputational and financial loss.
UNIT PRICING OR CREDITING RATES?

Another key change and area of debate within unit pricing over the past five years concerns unit pricing versus crediting rates. Most of, but not all, retail funds use unit pricing and a considerable portion of industry funds use crediting rates. Theoretically unitisation is a way to equitably attribute a share of the value of the pooled products to investors. To enable people to enter or exit a unitised fund, the price per unit is determined based on the number of units issued and the value of fund investments at the time the price is calculated.

The alternate method employed to attribute a share of the value of pooled products is the use of a crediting rate. Utilising this method an amount is credited to each person’s account based on the overall rate of return on investments and the amount invested by each person in the fund.

So what is the difference between the two and what has driven the change from crediting rates to unitisation?

First of all, it is important to note that both unitisation and crediting rates are valid and accepted methods of attributing value to investors. Achieving equity amongst investors is an important aspect to address when formulating a fund’s valuation policy. Many debates around the ‘equity’ consideration between unitisation and crediting rates often overlook other key factors within the valuation process. Two of these include frequency and ‘forward vs. historic’ pricing methodology. All things being equal, there should not be any difference in an investor’s wealth as a result of the scheme operator applying either a unitised or crediting rate methodology.

Within the industry there are still industry funds using a crediting rate methodology and applying flows under a historic methodology. This is a prime example where there are the potential equity considerations, especially in the event of significant market fluctuation that could favour or disfavour members.

Accordingly, this is one reason why industry funds have decided to adopt a unitised valuation policy. Evidently this position could be further strengthened as industry funds have commenced offering more investment options with the rising interest and resulted in the overwhelming conclusion that this is a considerable portion of industry funds use crediting rates.

Whether scheme operators adopt either structure or consider moving to unitisation, it is important for the operator to ensure that each component within the investment and valuation process is addressed accordingly and accommodates the transactions activity of both the fund manager and investor in an equitable manner.

Whilst the ASIC/APRA ‘Guide to Good Practice’ addresses both methodologies and concludes that both are commonplace and effective in valuing investor’s assets in pooled schemes, it does state that unitisation may be perceived as providing more transparency and result in more equitable treatment of beneficiaries and fund members.

Whichver method is chosen - crediting rate or unitisation – scheme operators must have increased awareness of the affect the adopted policy has on each stakeholder and therefore ensure their practices provide fair and reasonable outcomes for all beneficiaries and members.

RECENT REGULATORY REVIEW – ASIC/APRA

Both APRA and ASIC have regulatory jurisdiction for aspects of the practice of life companies, superannuation providers and funds managers. As a result of the identification of numerous unit pricing errors in recent years, ASIC and APRA undertook a joint review of the unit pricing practice in 2004.

From this there was a consultation paper published and released to the industry in late 2004 that detailed the findings of their review, and invited comments from industry participants to aid the development of a finalised version of the ASIC/APRA ‘Guide to Good Practice’.

So why was the review only undertaken in 2004 and what benefit does the Guide provide?

As mentioned above, the key driver to the ASIC/APRA review was the apparent increase in unit pricing errors. What was gradually being uncovered in the past five years was a litany of unit pricing errors across numerous financial services companies that had previously gone undetected.

The immediate impact of these revelations resulted in damaging headlines over unit pricing errors that soon progressed to companies making multi-million dollar compensation payments to investors along with the associated administrative costs of completing such a tedious exercise.

There are numerous examples available of organisations that have been faced with recent unit pricing errors that resulted in considerable costs to the firms along with the negative publicity over these errors.

Clearly something was wrong in the field of unit pricing, and the consequences of ‘getting it wrong’ soon captured everyone’s interest and resulted in the overwhelming conclusion that this is an area within the industry that is potential high-risk and deserves adequate attention.

The subsequent reviews by the relevant firms involved in the unit pricing errors were effective and ultimately ensured that no investor was adversely affected. The reviews generally consisted of examining the relevant events and circumstances leading to the unit pricing errors and providing detail of these reasons along with compensation/remediation plans to
investors. In addition to this the reviews commonly included enhanced procedures and associated actions to address the issues identified and thus prevent reoccurrence.

Although the reviews and undertakings were immensely effective, this did not address the issue from the perspective of the industry as a whole. There still remained doubt over whether or not the practice that had been adopted was appropriate, along with a general lack of clarity in many areas of unit pricing. For example, Tax provisioning and asset valuation methodology.

Whilst not being prescriptive, ASIC and APRA undertook the review and developed the guide to help product providers understand and comply with their unit pricing obligations. In accordance with their objective, ASIC/APRA noted a range of industry conduct that had the characteristics of good practice.

From this the guide to ‘Good Practice’ – not ‘best practice’ was created. This was not a mandatory set of instructions, but more of a tool to assist product providers in gaining a sound understanding of good practice in unit pricing and aid their commitment to implement an effective unit pricing practice.

In summary, the guide addressed a number of key areas that were categorised under the following topics:

1. Strategic unit pricing issues
2. Good practice principles
3. Pooled investments – unit pricing and crediting rates
4. Management issues
5. Technical issues
6. Consumer issues
7. Unit pricing obligations

In general, the industry has welcomed the regulators’ initiative in addressing this difficult area. It is noted that it attempts to address issues for the financial services industry as a whole, and is therefore generic in its recommendations. In accordance with their scope and objectives, the two financial service regulators have identified crucial operational, governance and technical issues surrounding the increasingly complex unit pricing process.

A direct outcome from the guides’ release has seen many unit pricing providers embrace its message of committing to implementing and maintaining an effective unit pricing practice. The first step in this process is for providers to ascertain the current state of play within their unit pricing practices and compare this to the recommendations outlined in the guide.

It is not expected that the providers or operators practice will exactly mirror the Guide to Good Practice, nor will their framework drastically change in the short-term. Although by ‘reading between the lines’, it is expected that a firm commitment is given by each provider or operator to actively ensure that its unit pricing practices are equitable amongst investors and are undertaken in a controlled environment. Unit Pricing providers must be able to substantiate all practices employed, and ensure that the entire process is regulated and frequently reviewed.

OUTSOURCING THE UNIT PRICING FUNCTION

In financial services globally, the use of outsourcing to both related and unrelated entities appears to be increasing and in many cases is the most practical option. In a recent survey, it was found that the most commonly outsourced functions are asset valuations and fund accounting. Superannuation providers generally outsource more than life companies and operators of managed investment schemes and, in particular, tend to outsource the calculation of unit prices and tax amounts.

So why do firms outsource and what are the benefits?

The decision to outsource must be strategic. Outsourcing is a significant investment that will affect the organisations bottom line, culture, risk profile, customer relationships, flexibility and day-to-day operations.

Outsourcing continues to be an important issue and is one that is clearly a determination for the board and senior management. The practice of outsourcing functions is evolving as organisations, both domestically and internationally; continue to identify opportunities and benefits.

One of the main arguments in support of outsourcing is the ability of the fund manager or scheme operator to focus on its core expertise. Whether it’s in insurance or custody, many organisations prefer to use someone with specialised expertise in that area. This also stems from the requirement for trustee boards to discharge their duties appropriately, thus calling for a far more objective view. While this may not result in the outsourcing of current in-house functions, it has encouraged them to access third party expertise to consult on the most appropriate practice for the organisation.

Other key differentiators when considering outsourcing the unit pricing function include the scheme operators’ focus on areas such as quality of service, risk management procedures and robustness of systems.

As such, the provider must be committed to having a strong control environment throughout the organisation. This controlled environment is achieved through:

- Employees who have extensive knowledge and experience in enhanced custody services.
- Appropriate procedures to ensure staff of appropriate calibre and background are hired.
- Ongoing development of staff.
- Clear and precise definition of duties and responsibilities of staff and clearly defined reporting lines.
- Establishment of policies and procedures for all functions.
- Independent risk management functions.

While fund managers and superannuation providers continue with their in-house or outsourced operations, there has been a subtle trend emerging in regards to individual function strategy. This is not characterised by the depth or range of services offered by custodians, but more so the trend towards ‘component outsourcing’.

As the term suggests, ‘component outsourcing’ is characterised by a segregation of duties that enables the scheme operator...
to relocate certain functions to the service provider. In many ways this seems a sensible approach, however it is something that may not be suitable for every organization.

At this point in time, the investment administration and custody sectors of the funds management and superannuation industry appear remarkably stable. Throughout the past ten years the custodian role has typically been ‘enhanced’ to accommodate all aspects of administration, reporting and analytical functions. This has grown to the extent that the value added services have become the norm and new services are being created.

The ‘component outsourcing’ trend is predicted to continue, especially on the superannuation front. As more and more super funds establish their own in-house investment teams, they require more back office services and more sophisticated reporting. Services such as compliance monitoring, unit pricing, risk management and attribution analysis are particularly in demand by superannuation providers.

When outsourcing the unit pricing function, it is of ultimate importance to ensure a successful partnership. So what does this mean?

The Guide to Good Practice provides a valuable overview of roles and responsibilities of each party.

Although it has been said many times before, when you outsource a business activity to a service provider, you are still accountable for the performance of the business activity. That is, the mantra of outsourcing the task but not the responsibility or risk.

One of the key focus areas within the outsourcing environment relates to the ability of the scheme operator to have sufficient knowledge of the outsourced function. This is to ensure that the scheme operator can effectively monitor the performance of the service provider and end-to-end unit pricing function; address any deficiencies in performance; and ensure continued compliance with all regulatory requirements.

An effective method of achieving this is to develop and implement outsourcing policy and procedures. This should be made reference to within another key document between the two parties – the Service Level Agreement (SLA). The SLA is a document that should detail the roles and responsibilities of each party and the relevant product area’s performing the tasks. Prior to committing to the services within the SLA, it is important that each party clearly understands and agrees to their respective requirements and responsibilities.

Whilst SLA’s are of utmost importance, it must be recognised that neither they nor contracts will not of themselves protect reputations. As the outsourced function is a critical business issue for both parties, each should satisfy themselves that they are working closely enough with each other in order to satisfy requirements and to get it right each and every time.

CONCLUSION

What does the future hold?

Within the changing landscape of financial markets, product innovation and increased regulatory scrutiny, the practice of unit pricing has had to evolve to keep pace with industry requirements and investor expectations. It is expected that this progression will continue in all areas of the financial services industry and thus place a continued emphasis on ensuring the activity and partnership chain between investment managers, trustees, custodians and other service providers is robust and transparent.

From an outsourced unit pricing perspective, this will typically involve more of a partnership approach over the longer term which will in turn prompt the development of more and varied services which are better suited to the service providers skill set.

There has been an abundance of value-add work undertaken and completed throughout the past few years. In honouring our commitment to our clients, regulators and investors of implementing and maintaining an effective unit pricing practice, it is important that we continue on this journey that will be a valuable and rewarding exercise for all concerned.