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Basel Committee on Banking Supervision
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London, February 20, 2015

BCBS Consultative Document: Fundamental review of the trading book: outstanding issues

Dear Sirs,

We welcome the publication of the Consultative Document *Fundamental review of the trading book: outstanding issues* (the "***Consultative Document***" or the "***CD***") by the Basel Committee on Banking Supervision (the "***Committee***") and we appreciate the opportunity to provide you with our comments.[1]

Markit is a leading global diversified provider of financial information services. We provide products that enhance transparency, reduce risk and improve operational efficiency. By setting common standards and providing tools that facilitate firms' compliance with regulatory requirements, many of Markit's services help level the playing field between small and large firms and herewith foster a competitive marketplace.[2] Our customers include banks, hedge funds, asset managers, central banks, regulators, auditors, fund administrators and insurance companies. Founded in 2003, we employ over 3,500 people in 10 countries. Markit shares are listed on Nasdaq under the symbol MRKT.

Markit has been actively and constructively engaged in the debate about regulatory reform in financial markets, including topics such as the implementation of the G20 commitments for OTC derivatives and the design of a regulatory regime for benchmarks. Over the past years, we have submitted more than 115 comment letters to regulatory authorities around the world and have participated in numerous roundtables. We also regularly provide relevant authorities with our insights on current market practice, for example, in relation to valuation methodologies, the provision of scenario analysis, or the use of reliable and secure means to provide daily mid-market marks. We have also advised regulatory authorities on appropriate approaches to enabling a timely and cost-effective implementation of newly established regulatory requirements, for example through the use of multi-layered phase-in or by providing market participants with a choice of means for satisfying regulatory requirements.

Introduction

Markit is a provider of pricing and valuation services to a large number of participants in financial markets, including many banks around the globe. Our pricing and valuation services cover a variety of asset classes, including credit default swaps, bonds, loans, and exotic derivatives, across all regions. Based on our

[1] IOSCO Consultative Document: Fundamental review of the trading book: outstanding issues. December 2014.
[2] For example, Markit's KYC Services provide a standardized end-to-end managed service that centralizes "Know Your Client" (KYC) data and process management.

experience in providing these services for many years please find below our comments in relation to the Committee's proposed approach in relation to the identification of modellable risk factors.[3]

Comments

Over the last several years, and in particular following the Global Financial Crisis, many participants in the financial markets found it challenging to ensure the sufficient quality of the data they use for valuations and risk modelling of their positions in financial instruments. We are fully supportive of the increased regulatory focus on ensuring the sufficient quality of data that is used by firms for modelling purposes and the diligence that regulators expect today from firms in checking that the data they use is indeed representative. We equally appreciate the fact that many of our customers challenge us on the quality and transparency of our pricing and valuation services on an ongoing basis. We have always aimed to provide a high level of transparency around the inputs and techniques that we use to produce our prices, and we explicitly measure and display through various means the degree of uncertainty that is embedded in our data.

We regard the requirements for a risk factor to be classified as "modellable" that the Committee outlined in its October 2013 Consultative Document[4] as an example of the increased regulatory attention to the quality and reliability of data used by firms. The criteria proposed by the Committee include the existence of a "sufficient set of representative transactions in relevant products" to allow for an appropriate historical data series for the factor. The Committee proposed that, for the data to be regarded as "sufficient", prices would need to be both "real" and available". A price would be considered "real" if it is "a price at which the institution has transacted on an arm-length basis; it is a price for an actual transaction between two other (independent) third parties; and the price is taken from a firm (transactable) quote." Additionally the Committee stated that for a risk factor to be considered modellable, it should have "at least 24 observations per year, with a maximum period of one month between two consecutive transactions."[5]

We are concerned about these proposed requirements for the identification of modellable risk factors. We believe that, if they were applied as proposed, they would be ill-suited to achieve the goals of securing the sufficient quality and representativeness of the data that firms use whilst they could have a very significant negative impact on the activities of firms in financial markets and the broader economy. Specifically, we believe that, were the requirements to determine whether a risk factor is modellable applied as proposed, factors for the vast majority of asset classes and instruments would be classified as non-modellable, either directly or via their hedges.[6] This would significantly increase capital requirements of firms for a large variety of financial markets activities. As a consequence, firms would be incentivised to reduce their activities to only the most liquid financial instruments that would still qualify as modellable risk factors.

The Committee should note that similar concerns have been voiced by the financial industry more broadly. Specifically, in response to BCBS 265[7] a group of the major industry associations stated[8] that the BCBS' text on non-modellable risk factors is "prescriptive and very rigid to the extent that its strict interpretation and

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[3] BCBS Consultative Document: Fundamental review of the trading book: A revised market risk framework. October 2013.

[4] Id. at 27.

[5] Id. at 32.

[6] For a package of a hedged position the hedging leg will often be more tailored, less liquid, and hence even less likely to satisfy the proposed requirements.

[7] BCBS Second Consultative Document: Fundamental review of the trading book – BCBS 265 – Non Modellable risk factors framework. October 2013.

[8] ISDA, GFMA, IIF response to BCBS Consultative Document on the Fundamental Review of the Trading Book. 4 June 2014. *Available at* http://www2.isda.org/attachment/NjU1NA==/BCBS_FRTB_Non%20modellable%20risk%20factors_Final.pdf.

enforcement would prevent the appropriate use of data" and also not allow for "modelling practices that are currently accepted by both the industry and regulators."[9] To address these concerns the associations recommended the use of a principles-based approach that would rely on the industry's experience and practice with data quality, data availability and illiquidity risk factors.[10]

Recommendations

To address these concerns we urge the Committee to clarify several elements of its proposals on how to determine whether a risk factor is modellable. Such clarifications are designed to allow the Committee to achieve its objectives of risk factors only qualifying as modellable where the underlying data is of sufficient quality and representative whilst avoiding unintended consequences that could be caused by an overly prescriptive approach:

- Requiring the existence of "at least 24 transactions per year" that are "not more than 1 month apart" seems unnecessarily crude and, we believe, generally ill suited to achieve the goal of securing sufficient data quality. In the extreme such requirements could encourage the occurrence of "reference transactions" that will not add to the quality of the data but rather provide misleading data points. We recommend that, instead, the Committee require firms to demonstrate to their supervisors the quality and uncertainty of the prices that they use by other, reliable and recognized means. Such means could include, for example, the number of different data sources that are available as inputs, the range of the input prices that were available, or the relevant Additional Valuation Adjustments ("***AVAs***") that many firms will already calculate to comply with Prudent Valuation requirements.[11]

- It is not clear from the Consultative Document what would qualify as "relevant products."[12] The Committee should note that, if "relevant products" was defined narrowly as just the specific maturity of the specific instrument, the large majority of bonds and derivatives would automatically be regarded as non-modellable even if sufficient data was available for benchmark maturities or issues.[13] To avoid such potentially damaging result we encourage the Committee to define "relevant products" broadly, i.e., by accepting the use of data available for similar or related products and/or of interpolation as long as the benchmark maturity or issue satisfied the requirements in relation to liquidity, quality of pricing, and representativeness. This should also apply for bonds where matrix-based pricing will often used to maximize the quality of the pricing by deriving the valuation of a bond from a whole range of different inputs, including data for other bonds of the same issuer.[14]

- We encourage the Committee to clarify whether it envisaged the overall process in relation to "modellable risk factors" to be performed in one or two stages. Specifically, we do not believe that the prices that are

[9] ISDA response to BCBS CD

[10] The associations (ISDA, GFMA, and the IIF) present a set of overarching principles regarding the modellability of risk factors.

[11] EBA Final draft Regulatory Technical Standards on prudent valuation under Article 105(14) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR). 23 January 2015.

[12] For example, the Consultation speaks of applying "instrument-level sensitivities to [asset class specific] risk factors" but is unclear what constitutes a specific instrument for the purpose of this analysis. Consultation at 8.

[13] For example, for a derivative product where the benchmark maturity of 5 years trades on a regular basis whilst the 4.5 year maturity, which the firm needs to model or holds a position in, does not.

[14] "Using the yield spread of blended yields to determine the yield of the bond is often called *matrix pricing*. In matrix pricing, pricing or quoting a bond depends upon the market prices of actively traded bonds that reflect benchmark prices. Matrix pricing often does not depend on any financial modelling, but compares a bond against bonds similar in terms of their characteristics, such as maturity, coupon rate, sector, and rating." The Oxford Guide to Financial Modeling: Applications for Capital Markets, Thomas Ho and Sang Bin Lee (2004), at 265.

used to determine whether a factor is modellable will always be equally relevant for the actual modelling of this factor. This is because the relevant transaction price that might be used for the determination of whether a factor was modellable, might be weeks old at the time of the actual modelling and hence not relevant for this purpose. We therefore encourage the Committee to confirm that the process in relation to modellable risk factors and related data usage consists of two stages. Specifically, in stage 1 the firm would determine whether the factor is modellable based on the Committee's refined requirements in relation to the underlying data. In stage 2 the firm would choose the data that is most appropriate for the actual modelling of this factor, which, where appropriate, could be different from the data it used for the determination in stage 1.

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We hope that our above comments are helpful to the Committee. We would be more than happy to elaborate or further discuss any of the points addressed above in more detail. In the event you may have any questions, please do not hesitate to contact us.

Yours sincerely,

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