



4th floor
Ropemaker Place
25 Ropemaker Street
London
EC2Y 9LY
United Kingdom

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

Capital Markets Policy Division
Markets Policy & Infrastructure Department
Monetary Authority of Singapore
10 Shenton Way, MAS Building
Singapore 079117

Submitted to SFA_FAA_LegisConsult@mas.gov.sg

London, September 01, 2014

Consultation Paper on Proposals to Enhance Regulatory Safeguards for Investors in the Capital Markets

Dear Sirs,

We welcome the publication of the **Consultation Paper on Proposals to Enhance Regulatory Safeguards for Investors in the Capital Markets**¹ (the “**Consultation Paper**” or the “**CP**”) by the Monetary Authority of Singapore (“**MAS**”) and we appreciate the opportunity to provide you with our comments.

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics for internal capital models, and related services across regions, asset classes and financial instruments. Our products and services are used by numerous market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities.²

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 100 comment letters to regulatory authorities around the world and have participated in numerous roundtables. We also regularly provide the 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.

Comments

We welcome MAS’ view that the availability of a wider range of investment products “is beneficial to the investing public”³ and its objective to “empower investors to make informed decisions”⁴ in relation to more complex investments. We generally support the use of simple signposts such as “ratings” that quantify the complexity and the risk of an investment product for this purpose. To achieve this objective, though, it will be of crucial importance that such ratings are indeed an accurate, comprehensive and dynamic reflection of the

¹ MAS Consultation Paper: “Proposals to Enhance Regulatory Safeguards for Investors in the Capital Markets.” July 2014.

² Please see www.markit.com for further information.

³ CP p. 4

⁴ CP p. 19

actual riskiness of the investment products. However, given how MAS proposed for these ratings to be determined we are concerned that they may often be only an inaccurate and/or an incomplete representation of the risks inherent in the investment product, they would not be consistent across firms nor would they be dynamic over time. As a consequence, we believe that the risk and complexity ratings as proposed would often send misleading signals to investors and provide them with a false sense of comfort.

Please find below our more detailed analysis of MAS' proposal and our thoughts on how the design of the risk ratings could be improved. Our comments reflect the experience that we have gathered providing our customers around the globe with Portfolio Valuations⁵ and Analytics⁶ services, often in relation to their investments in complex financial products.

- ***Q8. MAS seeks views on the proposal to introduce a framework by which products can be rated for both their relative complexity and risk.***

In the Consultation Paper MAS proposes requiring product issuers to assign a complexity rating and a risk rating (the "**Risk Rating**") for investment products⁷ and disclose these ratings to retail investors. The Risk Rating, or "risk of loss bucket", could be Low, Medium, High, or Very High reflecting the risk of losing the full investment amount⁸ or even more⁹ at maturity. On that basis, MAS also identified which risk categories specific financial instruments would be assigned to.¹⁰

We generally welcome MAS' proposal for product issuers to rate the investment products they offer based on their complexity and risk and disclose those ratings to investors. We believe that, if such ratings were appropriately defined and assigned, they could provide investors with useful information for their investment decisions. We also appreciate that the proposed methodology of assigning different types of financial instruments to specific risk categories would be fairly simple and straightforward. However, as we explain in more detail below, we believe that the design of the Risk Ratings ought to be significantly improved in several aspects in order for them to not send misleading signals to investors.

⁵ Markit Portfolio Valuations has been serving buy-side customers since 2005, today covering an extensive range of financial instruments including complex and illiquid products. Customers choose our valuation and risk analysis services for the accuracy and transparency of our results, the comprehensive coverage we provide through a single interface, and our expert and timely support across all regions. We deliver cost-effective solutions for portfolios of any size and composition, and we can offer reliable same-day turnaround to meet customer needs.

⁶ Markit Analytics delivers a suite of integrated, scalable and efficient solutions for enterprise-wide risk management across a broad range of asset classes. Its fully interactive interface allows for dynamic, on-the-fly risk reports as well as the ability to slice and dice results. Markit Analytics supports the highly variable computational demands of financial institutions by leveraging its software over a server grid. The flexibility and open structure of the solution's underlying architecture means that clients can customise or integrate new models very simply.

⁷ CP Part II: Complexity-Risk Ratings Framework for Investment Products.

⁸ Low, Medium, or High risk

⁹ Very High risk

¹⁰ Specifically, AAA rated corporate bonds and Singapore government bonds would be classified as Low Risk, IG bonds, non-concentrated non-leveraged and non-synthetic REITS as Medium Risk, single shares and bought options as High risk, and futures, written options, and CFDs as Very High Risk. See Table 2, CP p. 26.

- **Q11. MAS seeks views on the proposal to adopt a risk-bucketing approach that focuses solely on the risk of loss that investors face when investing in a product.**
- **Q12. MAS seeks feedback on the general categorisation of investment products into risk of loss buckets as set out in Table 2.**

We are generally supportive of the provision of risk ratings for investment products to retail investors. However, as long as such ratings are based on a “simple pre-determined “bucket-based” approach”¹¹ that focuses just on the worst case scenario, they are unlikely to accurately reflect the actual inherent risk of an investment. They would thus often send misleading signals to investors or provide them with a false sense of comfort. We are also concerned about the fact that these ratings would be static over the lifetime of the product¹² and hence not reflect any changes in circumstances.

Specifically, our concerns are as follows:

- The proposed Risk Rating is designed to reflect only the risk of loss of capital at maturity.¹³ It thus assumes that the investor intends to hold the investment to maturity and does not reflect other risks that are typically inherent in a financial product and equally relevant for most investors. For example, it would neglect the market risk of the investment during its lifetime which matters in particular for investors which may need to exit the investment before maturity. Further, it would not reflect the liquidity risk or the inherent valuation uncertainty of the product, both of which have recently attracted significant regulatory attention.¹⁴
- As the proposed Risk Ratings reflect only the “worst case scenario” at maturity, they would often only be a fairly inaccurate measure of the actual *risk* of loss at maturity. For example, according to the CP a futures contract on a government bond would be classified as “Very High Risk” whilst an IG rated corporate bond would only be classified as “Medium Risk”. Also, a futures contract on a government bond would be classified into the same risk category as a futures contract on a high yield bond. In both cases, the Risk Rating would not be a true representation of the *risk* of loss of these two products as it does not reflect the difference in the riskiness of the underlying.

In sum, we believe that the Risk Ratings as proposed in the CP would not only be an incomplete representation of the overall riskiness of an investment product but they would often not even accurately represent the risk of loss at maturity. We believe that MAS could address these shortcomings by reconsidering how the Risk Ratings are assigned. Specifically, to provide investors with a fair reflection of inherent risks of the investment the Risk Ratings should accurately measure the actual risks of loss at maturity,¹⁵ while also reflecting other relevant risks¹⁶ such as the market risk, the liquidity risk, and the valuation risk during the lifetime of the product. The calculation of such risks should be based on available market data and any such risk ratings should be updated if significant changes occur during the lifetime of the product. When disclosing such comprehensive Risk Rating to investors, the various risks of the investment product could be summarized in a single risk rating. However, given their relevance for individual investment decisions, it would be useful for investors to also have access to the ratings for the different risk sub-categories.¹⁷

¹¹ See CP p.25

¹² “A product’s complexity-rating and risk of loss bucket should be fairly static over its lifespan, ..”, see CP p. 31.

¹³ “... (ii) risk, being the likelihood of losing the principal investment amount.” See CP p. 19.

¹⁴ European Banking Authority Consultation Paper: Draft Regulatory Standards on prudent valuation under Article 105(14) of Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR). 10 July 2013.

¹⁵ For example by incorporating market-based measures of credit risk and volatility.

¹⁶ We note that MAS itself acknowledged in the CP that “A risk-rating methodology based on factors such as volatility, liquidity, credit, duration/cash flow, leverage and diversification, could in theory be used to rate a product’s riskiness.” See CP p. 25

¹⁷ Specifically, some investors will assign a higher weight to some risks than others, e.g. for an investor with a shorter time horizon the liquidity risk of the product will have more relevance than for a typical hold-to-maturity investor.

MAS should also note that, in line with requirements recently established by the CFTC in the swaps markets,¹⁸ investors might benefit from receiving a scenario analysis for certain investment products, e.g. for those that are highly complex and exceed a risk rating threshold. Experience has shown that the provision of a scenario analysis can significantly enhance the ability of investors to assess the risks of investing in a particular product, reduce informational asymmetries between product issuer and investor and empower investors to evaluate the risk of an investment under circumstances that are most relevant to them. To reduce the cost associated with providing such scenario analysis, product issuers should be allowed to rely on a third-party to provide it.¹⁹

- **Q16. MAS seeks views on whether a historical volatility (or credit rating for debentures) indicator should be used alongside the complexity-risk ratings framework. If so, should the indicator be used for products in the “medium”, “high” and “very high” risk of loss buckets or a more limited set of products?**

MAS proposed that a “Historical Price Volatility Indicator”, calculated as the standard deviation of the annualized weekly returns over the past 10 years, can be disclosed alongside the risk of loss bucket. It further clarified that such indicator would only be relevant for the medium, high, and very high risk buckets.²⁰

As stated above we believe that it is important for Risk Ratings to reflect all of the risks that the investor is actually exposed to through the investment and to base any underlying risk calculations on actual data. We therefore welcome the fact that MAS considers the use of a volatility rating that is based on historical data. We believe that the disclosure of such rating could highlight the potential market risk and price volatility that an investor could be exposed to during the lifetime of the investment. We therefore agree that it would be useful for a historical volatility indicator to be used. We also believe that the provision of such indicator would provide relevant additional information for investors across all risk categories, i.e. including the low (default) risk instruments, at least on a voluntary basis.²¹

- **Q17. MAS welcomes suggestions on the approach to be taken where information to calculate the historical price volatility indicator is unavailable.**

We understand MAS’ concern about situations where no sufficient data is available to calculate the historical price volatility indicator. However, we do not believe that such concern should be a reason to decide against the calculation of such indicator as similar challenges in relation to the lack of data have also been dealt with by regulators in a different context.²²

¹⁸ The U.S. Commodity Futures Trading Commission (“CFTC”) has recently established a requirement that for high-risk bilateral swaps that dealers would have to provide a scenario analysis designed in consultation with the counterparty to allow the counterparty to assess its potential exposure in connection with the swap, if the counterparty requests such a scenario analysis. Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 Fed. Reg. 9734 (Feb. 17, 2012), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-1244a.pdf>.

¹⁹ In order to make this option economically viable third-party assessors should not be held directly liable for these scenario analyses and instead be subject to market discipline for errant scenario analyses.

²⁰ CP Par 2.23.

²¹ Importantly, experience has shown that even an investment that is very safe from a maximum loss at maturity perspective can experience significant price volatility during its lifetime. Further, price volatility can often differ significantly even between products that carry the same default risk, e.g. AAA-rated ABS and AAA-rated government bonds.

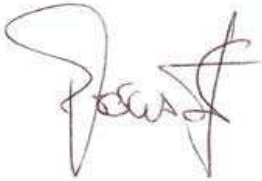
²² For example for the creation of proxy spreads as basis for CVA calculation. See EBA Final draft Regulatory Technical Standards on credit valuation adjustment risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383(7) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR). December 20, 2013.

We agree with MAS that, where the available data is not sufficient for the calculation of this indicator, proxies should be used.²³ Whilst we agree with MAS that the choice of proxies might involve a level of subjectivity we believe that the benefits for investors of receiving an indicator of price volatility should by far outweigh the risk of subjectivity that might be attached to it. We believe that relevant proxies should take into account the asset class, the rating, the maturity, and/or the industry of the exposure. We encourage MAS to establish a framework and provide some guidance around the use of proxies for this purpose.

* * * * *

We hope that our above comments are helpful to MAS. 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,

A handwritten signature in black ink, appearing to read 'Marcus Schüler', with a stylized flourish at the end.

Marcus Schüler
Head of Regulatory Affairs
Markit
marcus.schueler@markit.com

²³ "MAS notes that such information may not always be available .. and a proxy may need to used." See CP p. 29