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Tuesday, 8 October 2013

European Banking Authority
Tower 42 (level 18)
25 Old Broad Street
London EC2N 1HQ

Submitted via www.eba.europa.eu

Re: **Draft Regulatory Technical Standards on prudent valuation under Article 105(14) of Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR)**

Dear Sir/Madam:

Markit¹ is pleased to submit the following comments to the European Banking Authority (the “**EBA**”) in response to its Consultation Paper on *Draft Regulatory Technical Standards on prudent valuation* (the “**Consultation Paper**” or the “**CP**”).²

Introduction

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

¹Markit is a financial information services company with over 3,000 employees in Europe, North America and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see www.markit.com for additional information.

² 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.

Markit has been actively and constructively engaged in the discussion regarding regulatory reform of the financial markets. We regularly provide regulatory authorities with our insights on current market practice, for example in relation to valuation methodologies, liquidity measurement, the use of reliable and secure means to provide daily marks, or pre-trade credit checks to achieve clearing certainty. We have also advised regulatory bodies on potential approaches to enable the timely and cost-effective implementation of newly established requirements, for example through the use of multi-layered phase-in or by providing participants with a choice of means for satisfying their regulatory obligations. Over the last several years, we have submitted over 90 comment letters³ to regulatory authorities around the world and participated in numerous stakeholder meetings.

We welcome the publication of the EBA's Consultation Paper on *Prudent Valuation* and we appreciate the opportunity to provide the EBA with our comments.

Markit's comments

We generally agree with the EBA's proposals on how firms should go about quantifying valuation adjustments to reflect the various factors that can influence the prudent value of the financial instruments they hold. However, we believe that there are some areas where the firms and their relevant service and data providers would benefit from additional clarification as discussed in more detail below.

Article 3 – Sources of market data

The EBA proposed that the market data that is used to determine a prudent value should include "a full range of available and reliable data sources". Specifically, it should include "all of the following:

- (a) Exchange prices in a liquid market;
- (b) Trades in the exact same or very similar instrument, either from the institution's own records or, where available, trades from across the market;
- (c) Tradable quotes from brokers and other market participants;
- (d) Consensus service data;
- (e) Indicative broker quotes; and
- (f) Counterparty collateral valuations."⁴

We generally agree with the list of data sources that the EBA has provided and we appreciate the fact that the CP specifies that the data used by firms must be "reliable".

³ This number includes responses submitted by MarkitSERV, a now fully-owned subsidiary of Markit Group.

⁴ EBA CP, Article 3, par. 2.

However, we are somewhat concerned that this list of data sources might be read as a hierarchy with the first sources being regarded as always being preferable to other sources that are further down the list.

We believe that such approach would not be helpful. This is because our experience has shown that every single source of pricing data, almost regardless of its nature and position on the above list, can potentially represent a valuable input, but will also need to be sufficiently scrutinized to ensure it is indeed representative. This is because the reliability of different data sources can vary substantially not only depending on the specifications of the product but also on the market situation, and this will also change over time. Our experience has shown that even the reliability of transaction prices cannot always be taken for granted, particularly where both sufficient incentives and opportunities exist for market participants to engage in “reference trades”. For these reasons we encourage the EBA to clarify that the list of data sources should not necessarily be regarded as a “hierarchy” or “waterfall”.

Article 8 – Calculation of market price uncertainty AVA

The EBA proposed that the market price uncertainty AVA could only be assessed to have zero value where the institution has firm evidence of a tradable price for a valuation exposure or a price can be determined from reliable data based on a liquid two-way market and the relevant sources of market data do not indicate any material valuation uncertainty.⁵

We are concerned that such requirement might create an incentive for producing so-called “reference trades” where market participants might artificially create a market. We also believe that further clarification of “material valuation uncertainty” would be beneficial. This is because it is a rather subjective term that contains significant scope to allow a firm to override a traded level if all the other evidence points to it being off-market. We therefore recommend that the EBA clearly state that firms, to determine the degree of valuation uncertainty, shall assess *all* available sources of information and make a judgment on that basis. We believe that, by doing so, the EBA could ensure that firms utilize more than just one transaction level for the purpose of calculating the market price uncertainty AVA.

The EBA further proposed that firms shall “calculate AVAs on valuation exposures related to each valuation input in the relevant valuation model. For non-derivative valuation positions, or valuation positions for which there is a directly observable price, the valuation input shall be the price of the instrument.”⁶

⁵ EBA CP, Article 8, par. 2.

⁶ EBA CP, Article 8, part 4(a).

We believe that additional clarification would be useful to explain what is meant by “a directly observable price.” We believe that it remains unclear from the CP whether this refers to any price that is publically available or just a price that can be assessed based on the use of expert judgment after considering all available data sources.

Additionally, the EBA proposed that, where a valuation input consists of “a matrix of parameters”, AVAs should be calculated based on the valuation exposures related to each parameter within that matrix. Where a valuation input does not refer to tradable instruments, institutions should map the valuation input and the related valuation exposure to a set of market tradable instruments. Under certain circumstances firms would be permitted to reduce the number of parameters of the valuation input for the purpose of calculating AVAs.⁷

We believe that additional clarification in relation to the “matrix of parameters” would be helpful, specifically what types of parameters firms should include in such matrix. If the EBA was referring to variables such as volatilities, forwards, risk free rates, dividends, skews etc. we believe that additional clarification is needed as such parameters cannot be directly mapped to market traded instruments.⁸

Finally, the EBA proposed that, to determine market price uncertainty AVAs, “where insufficient data exists to construct a plausible range of values for a valuation input firms shall use an expert-based approach based on qualitative and quantitative information available to achieve a level of certainty in the prudent value of the valuation input that is “equivalent to that targeted in (a)”. In such cases firms should notify competent authorities of the valuation exposures for which this approach is applied, and the methodology used to determine the AVA.⁹

We believe that it is not clear how firms could achieve a 90% confidence level by using an expert-based approach.¹⁰ This is because the inputs that are provided by an expert will, by their very nature, be subjective and therefore difficult to challenge except after the fact should an exit occur. We therefore recommend that, in situations where the available data is insufficient, firms should be permitted to construct a plausible range of values for a valuation input using an expert based approach, without the EBA explicitly requiring a 90% confidence level.

⁷ EBA CP, Art. 8, Par. 4(b).

⁸ Generally, a derivatives transaction will be valued on a price basis. To derive a volatility or forward from this price a model will need to be used. This step, however, introduces a degree of uncertainty, as different firms will use different models and/or assumptions for such process.

⁹ EBA CP, Art. 8, Par. 5(b).

¹⁰ As targeted in Par. 5(a).

Article 9 – Calculation of close-out costs AVA

The EBA proposed that, where a firm is able to demonstrate that it can close out its positions at the mid-price and it values the position at such level, the close-out costs AVA may be assessed to have zero value. However, in such case the firm would need to provide evidence that it is 90% confident that sufficient liquidity exists to support the exit of the related valuation exposures at the mid-price.¹¹

Based on our experience in measuring and providing liquidity indicators across a variety of asset classes and financial instruments,¹² we encourage the EBA to provide further guidance as to how a firm can achieve a 90% confidence level that a sufficient degree of liquidity exists for the financial product.¹³ Specifically, it would be helpful if the EBA confirmed that it would regard it as sufficient if the firm provided actual bid-offer levels and traded levels as evidence.

Article 11 – Calculation of Model risk AVA

The EBA proposed that firms should estimate a model risk AVA for each valuation model by considering the risk that arises because market participants use a variety of models or model calibrations (other than calibrations from market derived parameters) and no firm exit price is available for the product being valued. The CP states that the model risk AVA should be calculated by using either a range of plausible valuations produced on the basis of alternative appropriate modelling and calibration approaches or an expert based approach.¹⁴

We believe that model risk largely represents the risk that the model or the model calibration used is not representative of actual market levels. In practice, to minimize such model risk, firms will tend to source market levels, select the most appropriate model and then calibrate the model to reflect the observed market levels. In order to ensure that models and model calibration represent current market levels, firms will need to perform periodic checks based on sourcing current market data and/or participating in consensus services. Firms should also review the frequency with which their models require a recalibration and ensure that checks are performed at appropriate intervals. Additionally, they should look to source those calibration parameters that are not directly observable.

¹¹ EBA CP, Art. 9, Par. 3.

¹² Markit Liquidity Services provide independent measures of market liquidity for credit default swaps, fixed income securities, loans and structured products, through the provision of individual market metrics, such as bid/ask spreads, and calculated liquidity scores.

¹³ For example, would it suffice to demonstrate that the mid-price lies within the typical bid-offer range if that range was applied to each trade?

¹⁴ EBA CP, Art. 11, pars. 1-4.

The EBA should note that the model output uncertainty calculated by an individual firm will often be a combination of input data uncertainty and model calibration uncertainty given that input data often varies between firms and models. To quantify true model risk all market participants would need to use the same input parameters as well as model and model calibration to match market levels. The range of resulting model outputs would provide the real model uncertainty for that particular product across market participants.

* * * * *

Markit appreciates the opportunity to comment on the EBA's Consultation Paper on *Prudent Valuation*. We would be happy to elaborate or further discuss any of the points addressed above. 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
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