

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Via email to baselcommittee@bis.org

Consultative document *Proposed revisions to the Basel II market risk framework*

London, October 4, 2008

Dear Sirs,

Markit welcomes the publication of your Consultative document outlining the *Proposed revisions to the Basel II market risk framework* and we appreciate the opportunity to comment on it.

Markit is a financial information services company with over 1,000 employees in Europe, North America, and Asia Pacific. Over 1,000 financial institutions use our independent services to value financial instruments, manage risk, improve operational efficiency and meet regulatory requirements. Over the years Markit has accumulated a significant amount of expertise in the pricing and valuation of financial products across all asset classes, and we believe we are in a good position to comment on the issues surrounding data, data quality, valuation and liquidity measurement. Please find below a summary of our comments on your Consultative document.

Mark-to-market Frequency

In response to your requirement that market data should be updated at least monthly or in a more timely fashion if deemed necessary, we would like to emphasise that we provide daily prices on bonds, Credit Default Swaps, LCDS, credit indices, European Asset Backed Securities, and loans. Markit Totem, our price verification service for exotic derivatives – the product area that is probably most relevant to your purposes- that has provided month-end services for market makers for more than ten years, will in addition to the monthly service also produce daily prices before the end of this year. This daily service will be launched in response to increased demand from banks and regulators alike. The Totem daily service will cover the active part of the OTC derivative universe referencing equity, commodities, and foreign exchange underlyings. We expect it will contain around 70-80% of the universe of the month-end Totem service for these asset classes.

Data Quality and Valuation Adjustments

In response to your requirement to verify the consistency, timeliness, reliability and independence of data sources, we would like to clarify some of the key characteristics of our data as it is used by many banks for valuation and accounting purposes. Firstly, we want to emphasise that we are an independent data provider and source our data from all the relevant market makers for each specific product. We then apply a range of cleaning algorithms consistently for the price contributions that we received and, on that basis, provide daily consensus prices to our clients. We are completely transparent about the cleaning algorithms we use. Please note that we might develop them further in the future to allow for the inclusion of new data sources such as quotes or transactions, or to reflect market developments such as changes in liquidity or a wider distribution of contributions received. We

are also transparent about the quality and sources of our data. We provide clients not only with consensus prices but also with other relevant information such as range of contributions, names of contributors, and even rejected contributions for some asset classes including Asset Backed Securities. For other asset classes such as Equity Derivatives, we provide the standard deviation and skewness of the distribution of our contributions.

Your Consultative document mentions that less liquid positions have limited price transparency and that minimum data standards should be met. It also mentions that positions without actual market prices or observable inputs and less liquid positions will raise supervisory concerns. We would like to point out that even products that do not trade in the market will often be covered in consensus price services with a decent data quality. To allow our users to form their own view on the quality and reliability of each price point that we publish, we will provide them with the "depth" of a price, the range of contributions, and the freshness of the data. All these parameters form part of our "Data Quality Ratings" described in more detail below.

In relation to your comments on the potential need for valuation adjustments for third party valuations, we are of the view that adjustments might prove appropriate whenever valuations are performed, whether by the bank itself or by a third party, purely reflecting a potentially significant measurement uncertainty. Even "simple" prices such as exchange closing prices are often not an accurate reflection of fair value, and need to be treated with caution. A valuation performed by a company that offers full transparency about its underlying data and methodologies and uses models that are generally accepted and properly explained should be no more exposed to the need for adjustments than exchange closing prices or modelled broker prices. These might neither be sufficiently accurate nor do they provide the transparency to allow banks to "look through" the data in order to understand inputs and techniques.

Detailed Vega-Risk

In relation to your requirement to "capture vega-risk in a detailed fashion" and perform a volatility break-down by maturities we want to emphasise that our Totem service does indeed provide the complete set of information needed by banks to satisfy your requirements. As an example, for plain vanilla interest rate swaptions alone, we provide a total of 750,000 price points at month end that can be used to derive implied volatilities for all these strikes and maturities. Based on our pricing data for OTC option products, market makers will be in a position to derive implied volatility surfaces for all relevant underlyings in their entirety. As a client service, we also create volatility surfaces directly based on Totem data and standard market models.

Close out prices

We would also like to comment on your requirement that independently-sourced close out prices, including "exchange prices, screen prices, or quotes from several independent reputable brokers" should be used for the purpose of marking-to-market. In our view, none of the examples mentioned above represents a price at which the bank could definitely trade. Given that mark-to-market should reflect the best estimate of the current market price and consensus prices are regarded by many as the best estimate of "fair value", as stated recently by the IASB¹, it would be justified to add "consensus prices" to your list of relevant pricing sources. Similarly, when you refer to "only one available broker quote", we think you might also want to include a reference to consensus prices, such as "consensus prices based on a very small number of contributors" and/or with a "wide distribution of contributed prices".

Distressed Sales

Furthermore, we would like to respond to your requirement that for mark-to-market "the more prudent side of bid/offer" should be used unless the bank is a market maker, and the bank should use actual market prices or observable inputs even if the instrument is less liquid unless it is dealing with a "distressed sale". In our view you should be careful not to deviate from guidance on bid/offer and

¹ Draft document of the IASB Expert Advisory Panel: Measuring and disclosing the fair value of financial instruments in markets that are no longer active

"distressed sale" voiced by other bodies. We would refer to the IASB Expert panel which states that the number of situations where prices can be disregarded as they are "forced sales" should be very limited.

Measuring Liquidity

Finally we would like to respond to your requirements that banks must demonstrate that a liquid two way market exists, and your statement that it is "deemed to exist where there are bids/offers to sell/buy so that the price is reasonably related to the last sales price, or bid/offers are available within one day and settled at such price within relatively short time", and also to your requirement that adjustments need to be made for less liquid positions independent of the valuation technique, reflecting the "expected time to hedge, the bid/offer, the "availability of quotes (number and identity of market makers)", as well as the "average and volatility of trading volumes". In this respect we would like to present you with some of our thoughts on how to most accurately measure the liquidity of financial products.

The desired measure for the risk property "liquidity" of a financial product should reflect the ability of an investor to sell the product in the market within a certain time period at a level close to the current price. However the challenge consists in quantifying and measuring this potential future liquidity for financial products in an objective and accurate way. The measure should be observable, updated dynamically, forward looking, and it should be available for the majority of relevant products.

Unfortunately, liquidity is not only an important risk inherent to financial products, but is also notoriously hard to measure. Whilst some market participants would propose using actual trading activity in the past to measure potential liquidity in the future, the use of transactional volumes is exposed to a number of theoretical as well as practical issues, making them rather ill-suited for the desired purpose:

- Daily trading activity can only ever be observed for a very limited part of the universe of all tradable products, and only for a subset of these are trading volumes publicly available. Liquidity measures derived from actual trading volumes could only be computed for a small number of products, and could not really serve as the benchmark measure for liquidity for the population of the entire market.
- Even for products for which trading volumes are available on a more or less regular basis, additional information would be needed to derive real liquidity indicators. In CDS for example a relevant question would be whether an isolated trade of EUR 1bn notional with a 1 year maturity is really a sign of liquidity for this name in general.
- The fact that a product has not traded recently should not be regarded as proof that it is not liquid and that the investor could not sell it quickly if he wanted to. Some products that might not trade today because there just is not enough interest in them currently are potentially very liquid if you want to trade. Think of a tight spread name in CDS: it might not trade because no one cares to buy protection on such a high quality credit; however it will probably be very easy to receive quotes from a number of market makers and trade in size with a tight bid/offer, close to the current market price, if you wanted to trade it.
- Finally, as recent events have shown, the actual turnover of a product can dry up suddenly depending on the market situation, and past turnover has therefore proved not to be a consistent and accurate predictor of availability of liquidity in the future.

Given the described issues it is fair to say that, while it does have value as additional input, transactional data alone will not suffice to measure future liquidity for the whole universe of relevant products. Fortunately, there is a more reliable and appropriate way to measure the expected future liquidity of financial products in the form of our "Data Quality Rating", a parameter that we have been computing and publishing for many years based on the variety of daily market data contributions we receive.

Markit's Data Quality Ratings can be used as a good proxy to assess the liquidity of a product, given that they are derived from the following input parameters:

- The number of accepted pricing contributors for the product, i.e. the ones that are accepted after rejecting many others based on our cleaning algorithms;
- The freshness of the data, i.e. how recently the contributions were last updated by the contributors, and
- The range of accepted contributions, i.e. the difference between the highest and the lowest accepted prices.

All else being equal, a higher number of accepted contributors, a greater freshness of the data, and a narrower range of accepted contributions will lead to a higher Data Quality Rating. Importantly, it will also signal a higher liquidity for this product, as more market makers trade the name and will provide prices when needed, as they frequently update their prices which reflects the ability of an investor to receive a number of tradable prices quickly, and there is little disagreement about the current price, which implies a tight bid/offer spread for decent size should be expected. If all of these factors are in place, they signal that the investor will likely be able to liquidate a position quickly, and close to the current price when needed. Data Quality Ratings are dynamic and reflect changes in the underlying variables on a daily basis. A detailed description of the computation of Markit's Data Quality Ratings is available on request.

In addition to these three inputs, we are in the process of integrating quotes data, i.e. bid/offers that we receive from the market makers, as well as transactional data, where we have it, into this liquidity measurement concept. One way of doing so will be to give a higher liquidity rating to names that appear on a number of quote runs every day, as it signals that this name is traded actively by multiple dealers. We are also working on ways to take the quoted bid/offer into account, with a tighter bid/offer justifying a higher Data Quality Rating and expected liquidity.

Based on the current data set, we publish Data Quality Ratings for 2,100 Credit Default Swaps and 5,300 bonds globally. In CDS more than 10% of the names achieve a AAA rating for their liquidity, with 780 being in the AA, and 382 being in the BBB category respectively. In the universe of bonds, reflecting a smaller number of contributors, less frequent updates, and a wider range of contributions, the majority of the bonds will fall into the BBB and BB categories, an indication of the generally lower liquidity of bonds compared to CDS.

We hope that these comments will be of value to you. Please don't hesitate to contact us if you require additional information or if you would like to discuss these ideas further.

Kind regards,



Tom McNerney
Managing Director
Data and Analytics
Tom.Mcnerney@markit.com



Marcus Schuler
Managing Director
Regulatory Affairs
Marcus.schueler@markit.com