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Submitted via www.eba.europa.eu

London, 13 August 2015

Consultation Paper *Draft Regulatory Standards - On the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)*

Dear Sirs,

Markit is pleased to submit the following comments to the European Banking Authority (the “**EBA**”) in response to its Consultation Paper *Draft Regulatory Standards - On the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)* (the “**Consultation Paper**” or the “**CP**”).

Markit¹ is a leading global diversified provider of financial information services.² Founded in 2003, we employ over 3,500 people in 10 countries and our shares are listed on Nasdaq.³ 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 120 comment letters to regulatory authorities around the world and have participated in numerous roundtables.

Introduction

Markit offers a variety of pricing and valuation services that are widely used throughout the financial industry. For example, we provide independent pricing and risk metrics for various asset classes and instruments including fixed income cash products, vanilla and exotic derivatives, private equity instruments and structured notes.⁴ We further offer a variety of services that help market participants validate their price and valuation adjustments for OTC derivatives across asset classes.⁵ We have also recently started providing an “External Valuer” service to European fund managers under AIFMD.⁶ On that basis we feel well positioned to comment on issues related to the valuation of positions in financial instruments in the context of the BRRD.

¹ See www.markit.com for more details.

² We provide products and services that enhance transparency, reduce risk and improve operational efficiency of financial market activities. Our customers include banks, hedge funds, asset managers, central banks, regulators, auditors, fund administrators and insurance companies. By setting common standards and facilitating market participants’ compliance with various regulatory requirements, many of Markit’s services help level the playing field between small and large firms and herewith foster a competitive marketplace. For example, Markit’s KYC Services provide a standardized end-to-end managed service that centralizes “Know Your Client” (KYC) data and process management.

³ Under the ticker MRKT.

⁴ See <http://www.markit.com/product/portfolio-valuations> for more details.

⁵ See <https://www.markit.com/Product/Totem> for more details.

⁶ Under AIFMD article 19.4(b), valuations performed by the asset valuer must be functionally independent from the portfolio valuation team and have a separate remuneration policy. Please also see: <http://www.privateequitywire.co.uk/2015/06/19/225487/markit-launches-aifmd-external-valuer-service>.

We welcome the publication of the CP by the EBA and the opportunity to provide you with our comments. Specifically we believe that the EBA should **(a)** clarify the hierarchy of data sources from the list it proposes for valuations, and assign a preference to the use of independent data; **(b)** ensure that adjustments to bid-offer spreads used to reflect valuation uncertainty be consistent with other regulatory work streams of the EBA, specifically the Prudential Valuation requirements; **(c)** make use of model prices where transaction prices are not available; and **(d)** employ the “optional early determination” using model prices where appropriate.

Q 4) Do you agree with the preferential status given to commercially reasonable replacement trades? Should there be also a prioritisation among other sources of data?

Q 5) Do you agree with the method described under paragraph 2 for the resolution authority to calculate the close-out amount? Is there a reason to believe that mid-market prices might not always be available or possible to derive from other data sources? And under which circumstances? In that case, what do you consider as an appropriate reference for calculating the close-out amount?

The EBA proposed that the valuer should determine the close out amount for the position in a financial instrument based on a) mid-market end-of-day prices, b) mid-to-bid or mid-to-offer spreads, and c) adjustments to reflect both the size and the creditworthiness of the counterparty.⁷ The EBA further proposed a list of data sources that the valuer may rely on for this purpose. This list includes data sourced from the firm’s own systems, from internal models and IPV functions, provided by counterparties, and provided by third parties “such as market data and quotes from market makers”.⁸

We appreciate that the EBA provides firms with guidance on how to compute a close-out amount for a position in a financial instrument and appropriate data sources to be used as input into such calculation. Whilst we agree that all of the sources listed by the EBA can have some relevance for valuation purposes we recommend the EBA clarify whether this list should be understood as a hierarchy or as alternatives. We recommend that the EBA regards these sources are treated as alternatives and the EBA highlight that the decision on which data source is most representative must be made by the valuer on a case-by-case basis, reflecting the nature of the individual data source, the type of financial instrument and the market situation. We further recommend the EBA consider that some of the data sources mentioned, for example marks provided by counterparties to the transactions, can be subject to significant conflicts of interest. As has been highlighted by the FCA in a recent Thematic Review,⁹ there is a risk that such counterparty marks are biased and might thus not be a sufficiently representative input into the calculation of the value of a replacement trade. To ensure that the prices that are used for the valuation of positions in the context of the BRRD are most representative we recommend that the EBA requires parties to assign a higher relevance/ranking to those data sources that are independent and not subject to such conflicts.

Question 6: Should adjustments to the bid-offer spread, other than those specified under Article 6(4)(c), be considered?

⁷ See Article 5.2.

⁸ See Article 5.4.

⁹ See FCA TR15/11: Financial Benchmarks: Thematic Review of Oversight and Controls, available here: <https://www.fca.org.uk/news/tr15-11-oversight-controls-in-relation-to-financial-benchmarks>. Specifically, on page 19, “Conflicts can arise via ... sending of trade data out of the firm (e.g. for valuation purposes).”

The EBA proposed that when there is no “evidence of actual replacement trades” the valuer should use adjustments to the mid-to-bid and mid-to-offer spreads taking into account the “size of the exposure” and “creditworthiness of the counterparty”.¹⁰

Our experience has shown that numerous factors that are specific to the position and/or the counterparty will have an impact on the valuation of a position. When a firm enters into a replacement trade, the data provided by the counterparty to the resolution authority for valuation purposes would be transaction-based and it would hence provide a reliable basis for the resolution authority to determine the close out amount. However, the adjustments referred to in this context are in the absence of “evidence of actual replacement trades”.¹¹ We therefore believe that the EBA should, consistent with its approach under CRD, employ adjustments that reflect the degree of uncertainty at the time of the bail-in of the derivatives positions. Specifically, it might make sense to consider the use of several additional valuation adjustments (“**AVAs**”) that are part of prudent valuation rules should also in the context of the BRRD.¹² AVAs reflecting liquidity risks, market price uncertainty and concentration risks seem most relevant for the determination of a “commercially reasonable” close out cost.¹³

We believe that the EBA should also consider that it might not be the most prudent approach to rely on market prices for the valuation, particularly at times when markets are likely to be stressed. We therefore recommend that resolution authorities are ready to make use of tools to determine model prices for replacement trades in situations where market prices are not available. On that basis a provisional valuation that is based on model prices could be used until market conditions improve.

Q 9 & 10) Do you consider this optional early determination appropriate, or do you consider that this option would unreasonably increase the risk of litigation or ex post compensation according to Article 74 of the BRRD? Alternatively, should resolution authorities always wait until there is pricing available in the market before producing their valuation, and therefore wait until that date before applying the bail-in tool?

The EBA proposed that the valuer “may produce its valuation of liabilities arising from derivatives earlier than at the point in time determined”.¹⁴

We believe that the use an “optional early determination” that would allow for the speedy resolution of the defaulting institution “on the basis of estimates” might be a sensible approach. Notably, it would be consistent with the principle of achieving the best possible results under the circumstances as it will not always be possible to source market determined prices or for counterparties to provide “reasonable” replacement trades. We believe that resolution authorities should make use of model prices as sensible estimate of the close-out cost and consistent with market practices,¹⁵ since it has been afforded the opportunity by the regulation to adjust the valuations once market prices are available. More importantly, as market confidence might deteriorate in a stressed market situation, herewith possibly increasing the cost of a replacement trade, delays could have an adverse impact on the bailing-in exercise of derivative liabilities.

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¹⁰ See Article 5.2(c)

¹¹ See Article 5.2

¹² See EBA Final draft RTS on prudent valuation under Article 105(14) of Regulation (EU) NO 575/2013 (Capital Requirements Regulation – CRR)

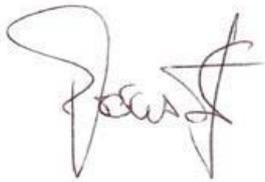
¹³ See *EBA Final draft Regulatory Technical Standards on prudent valuation under Article 105(14) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)*.

¹⁴ See Section 3, Article 7(1), 7(2)

¹⁵ Recital (10) of the CP mentions that any “hypothetical replacement cost for the close-out liabilities is consistent with predominant market practice”. The price determined under early determination option would classify as a hypothetical replacement cost and the use of model prices would be consistent with market practice.

We hope that our above comments are helpful to the EBA. 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 'Schüler', with a stylized flourish at the end.

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