

## **S&P Global Market Intelligence Response to European Banking Authority Consultation on Regulatory Technical Standards on Prudent Valuation**

S&P Global Market Intelligence (SPGMI) welcomes the opportunity to respond to the European Banking Authority's (EBA) consultation on amending Draft Regulatory Technical Standards (RTS) on prudent valuation under Article 105(14) of Regulation (EU) No 575/2013.

If it would be useful to explore any aspect of our response in more detail please contact David Henry Doyle, Vice President, Head of Government Affairs & Public Policy, EMEA, S&P Global ([davidhenry.doyle@spglobal.com](mailto:davidhenry.doyle@spglobal.com)).

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### **About SPGMI**

SPGMI is a leading provider of financial and industry data, research, news, and analytics to investment professionals, government agencies, corporations, and universities worldwide. SPGMI integrates news, comprehensive market and sector-specific data, and analytics into a variety of tools to help track performance, generate alpha, identify investment ideas, understand competitive and industry dynamics, perform valuation, and assess credit risk.

### **SPGMI Valuation Products**

SPGMI provides valuation services for fixed income, OTC derivatives, structured notes, and private equity investments. Our data, technology, and analytics solutions enable users to determine valuations for a range of financial assets including illiquid debt, suspended shares, private equity holdings, and unique assets.

In the derivatives space, we provide consensus financial market data, contributed by the active market participants, across a broad range of asset classes to support the independent verification of book valuations. Asset classes covered span equity, interest rate, FX, commodity, energy, structured credit, XVA, Structured Notes, Inflation and Repos. Data is based on consensus of contributed levels from the active market participants for each product, along with distribution information on the submissions such as standard deviation, range, and 10<sup>th</sup> and 90<sup>th</sup> percentile levels.

### **SPGMI Comments on EBA Consultation**

Our comments focus on Question 2 of the EBA consultation which relates to Article 3 of the RTS on Data Sources.

We share the EBA's objectives to ensure that information used to calculate Additional Valuation Adjustments (AVAs) is of the highest possible quality and reliability. We therefore

welcome the RTS “hierarchy of data sources for the purposes of determining AVAs to reflect observations regarding the accuracy and reliability of data from the different sources.”

As a provider of data sources, including consensus data, to the market we would like to share our observations on the changes proposed and their potential impact. Specifically, on the proposal to introduce a new limit on the number of contributions required to meet the range-based approach.

**Question 2. Do you have any comments on the amendments to Article 3 in general, and specifically with regard to the threshold of ten contributors set out in paragraph 2, point (d)? If you consider a different threshold should be applied, please describe how to set it, and provide a rationale and evidence supporting your proposal.**

The EBA proposes that the market data that is used to determine a prudent value should include “a full range of available and reliable data sources”. Specifically, the RTS indicate that the data should include:

*“one or more of the following market data sources:*

- a) exchange prices in a liquid market;*
- b) trades between parties at arm’s length 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 where the number of contributors is greater than or equal to 10 and the institution has performed a valuation backtesting.”*

*For the purpose of the first subparagraph, point (d), valuation backtesting refers to the testing of the data source to confirm that the data from this source is consistent with actual market transactions.”*

The EBA explanatory text for the amendments to Article 3 indicates that a new limit of 10 contributors for consensus service data referred to paragraph 2, point (d) has been derived from observed market practice. The EBA also explains that it considers that a lower number of contributors may make the AVA estimation “less reliable” and that “data from consensus data services with less than 10 participants would only be eligible in the context of the expert based approaches”.

We agree with the EBA’s intention and objective to define a hierarchy based on the accuracy and reliability of data from the different sources. However, we believe it is important for the EBA to consider that an overly simplistic focus on market depth for one market data source type, namely consensus service data and evaluated pricing, when determining its place in the hierarchy may ignore important market features and context.

All market data sources, including data sources higher in the hierarchy, can be more or less reliable as robust data points for a prudent value at a given time depending on the context of the market for the asset in question, including its size, whether it is a one- or two-way market,

and how the market is positioned. The reliability for the purposes of representativeness on data sources higher up the hierarchy should be seen in context.

For example, the reliability and accuracy of different data sources can vary substantially not only depending on the specifications of the product but also on the market situation in which it trades. Based on our experience, both factors can and do change over time. Our experience has also shown that even the reliability of transaction prices and tradable quotes cannot always be taken for granted, particularly where incentives and opportunities exist for market participants to engage in so-called 'reference trades' and the generation of quotes for the purpose of meeting regulatory requirements.

For consensus service data, our view is that accuracy and reliability is not achieved by a rule based exclusively on service participation thresholds or depth alone. A hard floor of 10 contributions across all markets for eligibility in the standard-range based approach may result in the absence of robust context relevant information for assets in lower volume markets or markets that typically feature more participants on one side of trading activity.

For example, equity Correlations are an example of a one-way market with high depth. For markets where liquidity contribution is concentrated among a relatively low number of dealers, but activity is still high, the suggested threshold of 10 contributors may not be appropriate.

In terms of potential market impact of a 10-contributor threshold, we estimate that 40-45% percent may be below this level across asset classes. In some asset classes, such as Credit Default Swaps, the number of data points below the 10-contributor threshold may be as high as 90%. As such, the potential second order effects of applying the expert based approach to significant amounts of trades should be considered prior to any threshold being determined.

In our experience, where a very large depth of participation exists, which in many markets represents the full population of market participants, there is a strong focus on accuracy and reliability based on a range of parameters, including but not limited to market depth. These additional parameters include, in addition to participation depth:

- a) Statistical studies of the relative and absolute movements of the contributed datasets and trends on the various consensus parameters over time;
- b) Systematic reviews and reports of contributed datasets and consensus parameters compared/corroborated to transaction data;
- c) Study of the nature of the market (e.g. two-way market or one-way market) and accessibility to data for the given product;
- d) A robust and well documented formal challenge process, including a systematic challenge process, which acts as a corroboration mechanism between the consensus and alternative data sources that aides market transparency and improves alignment.

It is therefore our view that the hierarchy should be based on a holistic analysis of each individual underlying factors listed above together as this forms a more reliable and accurate assessment of the consensus output.

Limiting consensus analysis to depth only, with an explicit requirement of at least 10 participants and a requirement of backtesting, would not achieve the EBA's intended objective of prudent valuations and AVAs being the highest quality, accuracy, and reliability. An approach that introduces a simple numerical threshold as a proxy for quality would ignore the necessary context in a market. It could also drive market behaviour away from a focus on quality, where consensus is challenged with quotes/transactions naturally occurring in the market, to a point where it becomes very difficult to determine if a quote is truly tradeable or not.

We would therefore suggest that the EBA consider whether a numerical benchmark in regulation for contributions to consensus-based assessments will achieve the objectives of more reliable and representative data for the purpose of prudent valuations. In our experience, a numerical threshold alone will not always provide the necessary context and information to assess how a market is behaving and where it is trading in terms of prudent valuations.

Separately, the consultation paper also makes an explicit mention that the institution needs to perform the backtesting. SPGMI generates various backtesting reports and it is our view that the institutions should be able to use such reports as an input into their backtesting process, as this will increase consistency in the methodologies applied as well as facilitate a level playing field across institutions. We note that consistency of methodologies and the importance of a level playing field are key objectives in various parts of the EBA consultation paper.

SPGMI appreciate the opportunity to comment on the EBA's draft amendments and we hope that our views are useful to your consideration of the functioning of the prudent valuation process. 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.