

Basel Committee on Banking Supervision  
Submitted via [baselcommittee@bis.org](mailto:baselcommittee@bis.org)

## **Supervisory guidance for assessing banks' financial instrument fair value practices**

London, January 19<sup>th</sup>, 2009

Dear Sirs,

Markit welcomes the publication of the Consultative Document on *Supervisory guidance for assessing banks' financial instrument fair value practices* by the Basel Committee and we appreciate the opportunity to provide you with our comments.

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. Some of our pricing services, such as Totem Valuations, have been operating for more than 10 years providing the market with fair value levels in over-the-counter derivatives. Totem Valuations collates market makers' best estimate of the mid-market price for all of the derivative instruments that they trade across all asset classes. Using these contributions, we create a single composite price for each instrument and maturity that is covered by the service. All prices are rigorously tested to ensure that they are appropriate given other pricing levels and market inputs. We have conducted continuous analysis and testing over the years and are of the view that the resulting prices are more representative of "fair value" than those from any other source, including inter-dealer broker prices, model based prices, or some closing prices of exchange-traded products.

Today, all major banks, broker dealers, buy-side clients, and commodities traders use Markit's services to assist them in the process of determining the fair value of their positions. Also, a large number of banks will incorporate Markit's independent price information in the preparation of their financial accounts.

That said we feel well positioned to comment on the issues relating to fair value and the inputs that banks will use to determine it. While we are generally supportive of your calls for a strong governance process around valuation, the use of reliable inputs from diverse sources, and transparency about valuation uncertainty we felt it would be helpful to provide you with our comments as well as with additional information about our pricing services that might help addressing some of your concerns. Please find below our response to your consultative document.

### **Undue Reliance on a Single Information Source**

We agree with your demand that banks should not place undue reliance on just a single source of information such as external ratings when assessing fair value, and that they should use a variety of approaches and cross check between different sources of data instead. It is worth pointing out that in our role as a data provider, we are following this approach ourselves, as we will try to get hold of all different sources of pricing data. On that basis we are currently in a position to validate many of our end-of-day consensus prices through the use of quotes or transactional prices where available.

As for the issue of “undue reliance” on credit ratings more specifically, we have been advocating the use of market-based measures to quantify the risk properties of financial products in a much more comprehensive and dynamic way. Market-based indicators, when calibrated properly, can not only be used to accurately quantify all relevant risk properties of a product, i.e. credit, volatility as well as liquidity risk, but they are also updated constantly based on market inputs. Please refer to our published responses to the consultations of the European Commission and the SEC on Credit Rating Agencies for details.

### **Reliability of Fair Value Estimates**

We support your view that banks can increase the reliability of their fair value estimates by maximising the use of relevant and reliable inputs and by incorporating all other important information. We also broadly agree with your view that, in order to assess whether a data source is reliable and relevant, users should look at the following characteristics:

- Frequency and availability of the prices, and what they are based on
- Consistency with available corroborating market information
- Transparency of the data
- Number of independent sources and dispersion of prices
- Maturity of the market

Most of the above factors will be taken into account in the operation of our pricing services for a variety of financial products. Please find below more details on how we try to ensure relevance and reliability of our data on the one hand, while maximising its quality and transparency on the other.

## a) Relevance and Reliability of Inputs

In response to your comments on how the relevance and reliability of data will depend on its source, we want to point out that the importance of transaction prices relative to other pricing sources is often overstated. Whilst we agree that transaction prices can be a useful input for valuation purposes, we are of the view that, when comparing the relevance and reliability of transactional data to end-of-day consensus prices or quotes, the following issues should be considered:

- Only a very small fraction of the total universe of financial products ever trades on a typical day. Even if the 5-year CDS for name A has traded today, knowledge of the traded price will not enable investors to come up with a spread for their positions with a 4.5-year, 3-year, or 10-maturity. Only a pricing service based on contributions for all maturities across the curve will be in a position to provide this wealth of information to the market.
- Whilst it is true that dealers do not submit actual transaction prices as their end-of-day book-of-record contribution, we think that this idea should not even be considered as it is often wrong to assume that a recent transaction price is the most reliable indicator of the current level. In contrast, as market makers would confirm, the fact that a product has traded at a certain level will be a strong reason for the current price to be different. To use an example: if the mid market price for a CDS on name A was 100bp, and a client sold a large amount of protection to the dealer at 100bp (transaction), the new mid market spread at the end of the day would probably be just 98bp (book-of-record price). Using the 100bp transaction price for the end-of-day valuation would clearly be inaccurate.
- Whilst dealers do not submit transaction prices to consensus pricing services, any trades that they have observed during the day will have an impact on where they set their book-of-record prices for that name and maturity at the end of the day, as described above. Furthermore, the dealer will also incorporate the observed trades into his marks for other maturities of that name and even the spreads of other names in a knowledgeable fashion. To use the above example: while the dealer will mark his 5-year point for name A at 98bp, he will probably also lower the spreads on other maturities for name A, and most likely not just by 2bp for all maturities, but reflecting his view on the shape of the curve. Also, he might decide to lower the CDS spreads for other names in the same industry that have not even traded on that day reflecting the trade in name A that he has observed.

To summarise the implications of the above example, while just one transaction occurred at 100bp for the 5y CDS referencing name A, book of record prices will not only reflect the accurate current mid market for this specific point at 98bp, but also the impact of this trade on the spreads for all other maturities of CDS on name A, as well as on the spreads of other related names if applicable.

Our above reasoning seems to be consistent with statements by the IASB Expert Advisory Panel in its report on *Measuring and disclosing the fair value of financial instruments in markets that are no longer active* that “for some markets, such as exotic derivatives, consensus pricing services might constitute the best available data”. All said, assigning a higher relevance or reliability to transaction prices compared to consensus prices seems to be somewhat ill-founded.

## b) Quality and Transparency of Prices

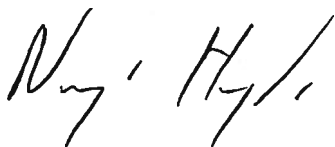
We do agree that the extent to which a user can rely on pricing data will depend on the number of sources, its dispersion, its transparency, and whether it can be validated using corroborating data. For all our pricing services we not only have a number of procedures in place to maximise data quality but we will also be as transparent as possible about the sources as well as the inherent uncertainty of our data:

- In addition to the actual pricing data, our clients will have access to a wealth of information allowing them to form their own view on the inherent uncertainty of our data. For all of our pricing services we will publish the range of accepted contributions, as well as the number and the actual names of the accepted contributors. Additionally, for products covered in Totem, we will provide the standard deviation and often also the skewness of the distribution of accepted contributions.
- The contributing market makers will receive data quality reports on a regular basis that they will use to analyse the quality of their marks and follow up with the relevant traders to address potential shortcomings. Participation in the Totem service in particular will often lead to greatly increased discussions between front and back office as the Totem data allows the back office to actively challenge traders' marks based on evidence obtained from their peer group.
- In addition to the numerous cleansing algorithms that we apply and on the basis of which we reject up to 60% of the incoming data for some products, we are increasingly using other sources of data to validate our end-of-day consensus prices, aiming to further improve the quality of our data:
  - Quotes data, i.e. bid/offer runs that we receive from the market makers, will allow us to assign a higher importance to end-of-day contributions from those dealers that are active in the name and provide quotes that are consistent with their end-of-day levels.
  - Also, for some asset classes such as leveraged loans, we have started using transactional data to validate our end-of-day consensus prices.
- We are of the view that not only the quantity, but even more so the quality of our contributors is of paramount importance to ensure that we receive only relevant and reliable data as input:
  - As to the number of independent sources that are included in our pricing services it will be fair to say that every market maker that is active in a specific product will contribute to the respective price verification service. For some new and complex derivatives, product control groups of banks will often make it a pre-condition for trading that the product has been added to the Totem service, as only this will enable them to perform a monthly independent price verification process.
  - That said, we have no intention to maximise the number of contributors, while we certainly aim to maximise their quality instead. We thus carefully manage the group of our contributors to ensure that all active market makers are

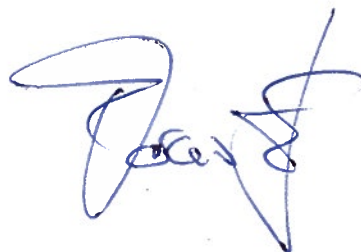
included, while contributions from those that are no longer active will not be taken into account. On that basis we have significantly reduced the number of contributors to some of our services over the last couple of years, as we identified some that had exited the business while others did not add any real value through their contributions.

We hope that our comments are of value to you. Please do not hesitate to contact us if you require further information or if you want to discuss any of our comments in more detail.

Kind regards,



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