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Submitted via: https://eba.europa.eu/ 02 October 2019

Consultation Paper: Draft Regulatory Technical Standards on Criteria for assessing the modellability of risk factors under the Internal Model Approach (IMA) under Article 325be(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation 2 - CRR2) (EBA/CP/2019/07 - June 2019)

I. Introduction

IHS Markit (Nasdaq: INFO) is pleased to provide its comments regarding the consultation paper (CP) on the draft RTS for assessing the modellability of risk factors under the Internal Model Approach (IMA) in the EU. IHS Markit is a world leader in critical information, analytics and solutions for the major industries and markets that drive economies worldwide. The company delivers next-generation information, analytics and solutions to customers in business, finance and government, improving their operational efficiency and providing deep insights that lead to well-informed, confident decisions. IHS Markit has more than 50,000 key business and government customers, including 80 percent of the Fortune Global 500 and the world's leading financial institutions.

II. Summary

IHS Markit welcomes the EBA's RFET framework set forth in the CP and would generally support the need to bring more clarity to some of the requirements described in the BCBS Minimum capital requirements for market risk and the EU Regulation CRR 2.

The EBA should be aware, however, that overly prescribed rules might not fit all and create undesirable complexity in an already complex set of rules. Therefore, we call for the EBA to consider relaxing some parts of its proposed rules.

However, there are some important points where we fully agree with the EBA's proposals. These include: the need to ensure consistent time-zone reporting; the safeguards requirements to ensure only sound prices are used in the RFET process; the rules of engagement with 3rd party vendors; and the principles verifying prices representative of RFs.

We also believe it would be prudent if the EBA added some guidelines to the requirement stipulated in MAR21.35 in the Basel rules, discussing treatment of equity investments in funds and, in particular, the need for "look-through".

III. Answers to CP Questions

Q1. Do you agree that a committed quote, to be considered verifiable, should be required to have both a firm bid <u>and</u> offer price? If you think that solely a bid or offer price should be sufficient please provide a convincing rationale.

We believe different markets have different quoting patterns/conventions and enforcing both bid <u>and</u> offer to a quote for every market would lead to the "loss" of many quotes that represented a commitment from the quoting party. For example, in the bond market we observe a clear distinction between dealer-to-customer (D2C) and dealer-to-dealer (D2D) quoting conventions. While the former is primarily one-sided (i.e. bid or offer) the latter can be predominately categorised as 2-sided (i.e. bid <u>and</u> offer). On the other hand, in the credit derivatives market we observed both D2C and D2D quotes to be predominantly 2-sided.

Moreover, we believe that the requirement for a quote to be "legally obliged" contradicts markets modus operandi where the commitment to trade on a quote is based on market conventions rather than a legal agreement between the counterparties to the quote.

Our recommendation is, therefore, to leave it to the banks to determine whether to use 1-sided or 2-sided quotes based on the different markets and their understanding of the quoting conventions of each market. One could consider that, if 1-sided quotes are being used, then banks should be looking also for supporting information within the quote, such as indication of "firmness" or "Axe" in the bond market.

Q2. Please provide an estimation of the impact of requiring solely a firm bid or offer price compared to requiring both. Please provide this impact e.g. in terms of number of nonmodellable risk factors, stress scenario risk measure charge or number of eligible committed quotes for different risk factors/ risk factor categories.

Due to the vast reliance of the cash bond market on quotes to prove modellability and as we have tens of millions of quotes in our database, we

focused our analysis on this market. Checking modellability of Risk Factors (RF) can potentially be misleading as different banks will have a different RF taxonomy so we decided to examine modellability on an instrument ID (ISIN or CUSIP) basis rather than other possible dimensions. Furthermore, we examined GSAC bonds and MUNI bonds separately. Finally, the analysis of the impact of imposing bid and offer is on quotes only and did not incorporate post-trade information into the overall population of RPOs.

GSAC Bonds:

- As discussed in the answer to Q1, D2C market tends to be 1-sided. Our observation shows that over 90% of the D2C quotes are 1-sided.

- The number of unique instrument IDs in scope when allowing only 2-sided quotes (vs. allowing both 1-sided and 2-sided) drops by ¬40%. However, the number of **modellable unique instrument IDs** drops by ¬24%. Reason being only ¬44% of the unique instrument IDs are found to be modellable when allowing both 1-sided and 2-sided while it goes up to ¬56% of the unique instrument IDs being modellable when using only 2-sided quotes.

MUNI bonds:

- Our research shows that the reliance of the MUNI bond market on quotes is larger than the general bond market with less than 25% of the quotes (per unique instrument ID) turning into an actual trade within the following week to the initial quote. Furthermore, the skew towards a 1-sided quote is even larger due to the fact these are mostly retail based, with very few D2D quotes (these also tend to be 1-sided).

- The number of unique instrument IDs in scope when allowing only 2-sided quotes (vs. allowing both 1-sided and 2-sided) drops by ¬96%. The impact of this on modellability can be looked at in 2 ways:

    1. On the one hand only¬3% of unique instrument IDs are modellable to begin with, even when using both 1-sided and 2-sided quotes [when ¬80% fail both modellability criteria (24 and 4in90 days RPOs)] so any move from both 1-sided and 2-sided will have limited impact on absolute change.

    2. On the other, due to the fact that there is a 96% drop of unique instrument IDs in scope, the total number of **modellable bonds** drops by 99.1% and therefore, they become virtually non-modellable across the board without using post-trade information.

Q3. How would you define and check for a "non-negligible volume of a transaction or quote, as compared to usual transaction sizes for the bank, reflective of normal market conditions" for the purpose of assessing the validity of a price observation?

In the FAQ published by the BCBS in January 2017 (https://www.bis.org/bcbs/publ/d395.pdf), the following Q&A was included, introducing for the first time the principle of "non-negligible volume" (paragraph 2.6; p.9):

> *Q4. Are all transactions and eligible committed quotes valid as real price observations, regardless of size?*
>
> *Answer: Orderly transactions and eligible committed quotes with a non-negligible volume, as compared to usual transaction sizes for the bank, reflective of normal market conditions can be generally accepted as valid.*

Following the introduction of the concept of "non-negligible" we decided, using IHS Markit's resource of over 2 million Interest-Rates Derivatives RPOs, to create a sense of what would constitute a "non-negligible" volume.

To do this we developed the following principles to remove "noise" in our data:

- Only "New" trades were included (i.e. no novation, amendment etc.);
- Converted domestic notional to US$ using relevant day FX spot rates to compare like for like;
- Split the check between Dealer-to-Dealer (D2D) and Dealer-to-Customer (D2C);
- Removed dealers with less than 20 trades in period checked; and
- Excluded all trades under $1,000 as a sanity measurement.

Our immediate findings were that there is no ideal number that fits all scenarios and a distinction between D2D and D2C as well as G4 versus non-G4 must be made. After running several statistical measurements, we came to the conclusion that the "benchmark" should be a D2C 1-percentile mark.

Our findings were that non-negligible threshold should be: G4 - $291,000; Non-G4 - $37,000.

It is also important to mention that we did not distinguish between instruments (i.e. swaps versus swaptions) or give different currencies different weights based on their overall volume (as set out, for example, in the BIS triannual report). Our analysis also did not distinguish between top tier-1 banks and tier-2 banks.

Regardless, our recommendation is that the EBA should not propose a single number and/or a single methodology as different asset-classes, instruments or currencies have different characteristics and levels of liquidity. Although we would not recommend it, if the EBA believes it must insist on a more quantitative approach in defining a threshold, we believe that using a D2C 1-percentile mark on different asset-classes, instruments and currencies might provide a workable threshold.

Q4. How would you define and check for an "unreasonably large bid-offer spread as compared to usual bid-offer spreads, reflective of normal market conditions" for the purpose of assessing the validity of a price observation obtained from a committed quote? In your response, please provide a detailed reasoning.

Our advice, as set out in our answer to Q1, is that the EBA should not impose a 2-sided quote only system as markets have different quoting conventions and these conventions are not legal agreements between counterparties. Therefore, we believe defining and checking bid-offer spread as set out in this question should be somewhat redundant. If the EBA takes the view that committed quotes should only be 2-sided, we would like to emphasise that defining and checking for an “unreasonable large bid-offer spread” would be extremely difficult.

However, we thought it would be helpful to share our findings on the distribution of the spreads observed in IHS Markit’s population of Cash Bonds (committed) quotes. This should help the EBA get a sense on how spreads behave, but, as illustrated in our previous answers, we believe this should ultimately be each bank’s own decision based on the information they have in-house or provided to them by a 3rd party vendor as enrichment to the core RPO information.

Spread (S)	%	Cumulative %
S<0.25	22.80%	22.80%
0.25<S<0.5	20.80%	43.60%
0.5<S<0.75	19.20%	62.70%
0.75<S<1.0	16.30%	79.10%
1.0<S<2.0	18.30%	97.30%
2.0<S<3.0	1.80%	99.20%
3.0<S<4.0	0.40%	99.60%
4.0<S<5.0	0.10%	99.70%
5.0<S<7.0	0.10%	99.80%
7.0<S<10.0	0.10%	99.90%
S>10.0	0.10%	100.00%

Q5. Do you see any problems with requiring that institutions are allowed to use data from external data providers as input to the modellability assessment only where the external data providers are regularly subject to an independent audit (independent of whether the price is shared with the institution or not)? If so, please describe them thoroughly (i.e. for which data providers and the reasons for it).

We believe that all 3rd party vendors should be regularly audited by an external audit firm, using a market acceptable audit framework. Moreover, we believe the vendors should be able to provide a public attestation of the audit to the banks. It is important to coordinate such requirements across jurisdiction to avoid vendors having to undergo multiple, duplicative audits.

Q6. Do you have any proposals on additional specifications that could be included in the legal text in order to ensure that verifiable prices provided by third-party vendors meet the requirements of this Regulation?

While the EBA is taking note of MAR31.26 of the Basel text in Q14 of this CP (in the context of calibration of banks' internal model), we believe the EBA should also recognise these principles in the context of ensuring the verifiable prices provided by 3rd party vendors are representative of the prevailing market prices.

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We hope that our 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 and also believe this would help the EBA develop policy in this area. In the event you may have any questions, please do not hesitate to contact Gil Shefi, Managing Director at gil.shefi@ihsmarkit.com.

Yours faithfully,

Gil Shefi

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