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Jennifer J. Johnson
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Robert E. Feldman
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions

    OCC: Docket ID OCC-2010-0003
    Board: Docket No. R-[1401]
    FDIC: RIN 3064-AD70

Ladies and Gentlemen:

Markit[1] is pleased to submit the following comments to the Prudential Regulators ("**PRs**" or "**Agencies**") in relation to their proposed rule regarding *Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions* (the "**Proposed Rule**").[2]

Introduction

Markit is a service provider to a broad range of participants in the global financial markets, offering independent data, valuations, risk analytics, and related services for financial products across regions and asset classes. Markit supports the objectives of the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] of increasing transparency and efficiency in the OTC derivatives markets, of reducing both systemic and counterparty risk, and of detecting market manipulation and abuse.

Executive Summary

We commend the Agencies for identifying various possible alternatives to credit ratings. However, we believe that certain aspects of the measurement methods proposed to be utilized by the Agencies may result in inadequate measurement of risk and creditworthiness in certain circumstances. That said, we believe that any method relied upon by the Agencies must take a number of relevant sources of information into account, be

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[1] Markit is a financial information services company with over 2,400 employees in North America, Europe and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see www.markit.com for additional information.

[2] Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions, 76 Fed. Reg. 79380 (Dec. 21, 2011).

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

forward-looking and sufficiently accurate, and leave room for the use of judgment where appropriate.[4] Further, we believe that the use of market-based measurements as inputs would provide many advantages, and that the challenges that might exist for using such measurements can be appropriately addressed.

Market-based methods of measuring risk and creditworthiness such as Credit Default Swap ("**CDS**") spreads and bond spreads are forward-looking, timely, and transparent, and they have often proven to be more accurate than other indicators in measuring the creditworthiness of issuers.[5] Given their many advantages, we believe that the Agencies should more seriously consider allowing the use of market-based measures as the basis for producing alternatives to credit ratings, in addition to the measurement methods proposed in the Proposed Rule. This is particularly true given that: (a) the OECD's Country Risk Classifications will often fail to appropriately represent creditworthiness of sovereign issuers; (b) the use of historical volatilities in the indicator approach will often result in producing inaccurate results; and (c) the perceived drawbacks of market-based measures such as limited coverage, liquidity, excessive volatility, and the impact of market-wide factors can be addressed.

1. **Measurement of Creditworthiness Should Be Forward-Looking and Be Based on Several Sources of Information**

The financial markets have evolved to provide independent indications of various product characteristics, including creditworthiness, liquidity and volatility. Such market-based measures are easily observable and transparent, updated frequently, and built on both the expectations and actual transactions of all relevant market participants. We believe that the only effective way to define the creditworthiness of an issuer that is flexible enough to account for the myriad differences that exist in the marketplace is to use a large and complementary set of relevant data while controlling for factors such as liquidity, volatility, and market risk. We further believe that certain market-based measurements of creditworthiness would accomplish these goals.

However, the Proposed Rule would not permit the use of such market-based means of measuring risk and volatility for certain instruments. For example, the Proposed Rule would only permit "specific risk"[6] for sovereign debt to be measured by using the OECD's Country Risk Classifications ("**CRCs**")[7] modified by a weighting factor for any sovereign that has defaulted on any exposure during the past five years.[8] Similarly, the Proposed Rule would only permit specific risk for corporate debt positions to be determined on the basis of an indicator approach that uses historical equity volatility as one of its inputs.[9] As described below, we do not believe that these limited methods will result in adequate measurements of creditworthiness in certain circumstances.

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[4] This is reflected in the approach that has been recommended by accounting experts for the valuation of financial instruments, particularly those that are hard to value. IASB Expert Advisory Panel: Measuring and disclosing the fair value of financial instruments in markets that are no longer active (October 2008).

[5] For the avoidance of doubt, our support for market-based measures does not necessarily imply that we regard them as the only acceptable or the best predictors of creditworthiness in all cases. However, we believe that, given their many advantages and the amount of information that they contain, they should play an important role as an input into measuring the creditworthiness of issuers.

[6] Specific risk relates to changes in the market value of a position due to factors other than general market movements. *See* Proposed Rule, 76 Fed. Reg. at 79383.

[7] The CRC classification, based only on valid country risk elements, is a consensus decision of the sub-Group of Country Risk Experts that involves the country risk experts of the participating Export Credit Agencies. This group meets several times a year. The meetings are organized so as to guarantee that every country is reviewed whenever a fundamental change is observed and at least once a year. Therefore, if no fundamental change occurs, a country may only be observed annually. A description of the CRC classification is available at http://www.oecd.org/document/49/0,3746,en_2825_499762_1901105_1_1_1_1,00.html (last visited Jan. 23, 2012). While the meetings are confidential and no official reports of the deliberations are made, the list of country risk classifications is published after each meeting.

[8] *See* Proposed Rule, 76 Fed. Reg. at 79402-03 (to be codified at 12 C.F.R. § __, Section 10(b)(2)(i)).

[9] *See id.* at 79390.

a. Description of the Proposed Methods to Measure Creditworthiness of Sovereign, Corporate, and Financial Issuers and the Shortcomings of Such Methods

Under the Proposed Rule, banks must determine the specific risk for sovereign debt positions based on a sovereign's CRC and apply a specific risk-weighting factor of 12.0% to sovereign debt positions where the sovereign has defaulted on any exposure during the previous five years.[10] While CRCs seem like an attractive alternative to the use of traditional credit ratings, we believe that the use of CRCs without also taking certain other measurements into account could often lead to unsatisfactory results, particularly for sovereign issuers with a CRC rating of 0 (*i.e.*, the highest CRC rating).

For example, we analyzed the creditworthiness measurements of 83 sovereigns by comparing their CRCs, CDS spreads, and traditional credit ratings. Of these 83 sovereigns, 33 received a 0 CRC in the most recent quarter. As a result, their specific risk-weighting factor under the Proposed Rule would be 0%.[11] However, CDS spreads (based on a 10 year maturity)[12] for these 33 sovereigns ranged from a mere 54bp p.a. to more than 75% p.a. Similarly, S&P credit ratings for these sovereigns varied between AAA and CC. Clearly, then, the creditworthiness of sovereign debt positions based on CDS spreads or traditional credit ratings would be much more granular and accurate. Moreover, we do not believe that CRCs are updated frequently enough to provide timely adjustments to credit measurements because they are only updated on a quarterly basis and rely on some data that is only made available annually.[13]

We believe that the Proposed Rule contains similar shortfalls in the prescribed method for determining the creditworthiness of corporate debt positions. Under the Proposed Rule, capital requirements for exposures to public companies that are not financial institutions would be determined on the basis of an indicator approach that uses historical stock return volatility as one of its inputs.[14] While historical equity volatility is simple to compute, it only reflects underlying movements of the shares in the *past*. However, capital requirements should provide a firm with a sufficient cushion against the risk of possible *future* events. We are concerned that, given its backward looking nature, the use of historical volatility for the calculation of capital requirements will not reflect the cyclicality of market movements, and might often lead to unintended results. Specifically, in a low volatility environment, historical volatility tends to understate the potential future movements of shares, and might therefore lead to capital requirements that could prove to be insufficient in the future.

b. The Agencies Should Endorse Market-Based Measures of Creditworthiness

Based on our experience in the provision of pricing services for CDS[15], bonds, and OTC derivatives, we believe that incorporating certain market-based methods of measuring creditworthiness into the Proposed Rule would improve the quality of the resulting specific risk-weighting factors.

i. *Specific Risk for Sovereign Debt Positions Should Incorporate Various Market-Based Measurements*

The Agencies considered the use of sovereign bond spreads but were concerned that sovereign bonds are denominated in various currencies as opposed to U.S. dollars and that spreads calculated from these

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[10] *See id.* at 79402-03 (to be codified at 12 C.F.R. § __, Section 10(b)(2)(i)).

[11] *See id.* at 79402-03 (to be codified at 12 C.F.R. § __, Section 10(b)(2)(i)).

[12] We have used CDS spreads for the 10 year maturity as this tends to be most liquid for sovereign CDS.

[13] *See infra*, n. 6.

[14] *See* Proposed Rule, 76 Fed. Reg. at 79390.

[15] For CDS we currently provide spread curves for approximately 3,000 individual entities. These CDS spreads are based on CDS data contributed from market makers which then undergoes a cleaning process to test for stale, flat curves, outliers and inconsistent data.

sovereign bond yields would reflect factors other than credit risk (such as the inflation rate of the non-U.S. dollar currency the bond is denominated in).[16]

Markit has provided pricing services for bonds for many years. Today, our Evaluated Bond ("*EB*") service produces bond curves for more than 6,200 issuers, including over 350 governments and Supranationals, and more than 1,400 financials.[17] We assign several different bond curves to issuers depending on the currency of issuance and other characteristics such as the issuance amount (*e.g.*, retail vs. institutional issuance size) and coupon frequency (*e.g.*, fixed rate bonds vs. Floating Rate Notes).

Based on our experience, we can confirm that many issuers have not issued any bonds in U.S. dollars.[18] However, we believe this can be addressed by either: (i) using the CDS curve for the specific issuer (that will generally be available in U.S. dollars); (ii) deriving an issuer-specific CDS spread from the appropriate CDS sector curve[19] (in case this issuer is not traded in the CDS market); or (iii) deriving an issuer-specific U.S. dollar bond spread curve of the issuer from existing bond curves in other currencies.[20] In general we believe that the lack of available spread data in U.S. dollars is less of a concern for structured finance instruments.[21]

We are open to discussing the possibility of establishing such approaches with the Agencies and other stakeholders in more detail.

> ii. *Specific Risk for Corporate Debt Positions Should Incorporate Implied Volatility and Bond or CDS Spreads*

As described above, we believe that deriving the specific risk-weighting factor for a corporate debt position that is an exposure to a non-financial public company from historical volatility is not ideal, as it is a backward looking measure. In contrast, implied volatilities that are derived from prices of traded equity options incorporate a forward-looking perspective. Because they are based on daily mark-to-market, reflecting the market price of entering or exiting a position at that time, they more accurately represent market expectations of risk.[22] The Agencies should therefore allow for the specific risk-weighting factor to be based on implied volatility rather than historical volatility.

Additionally, we believe that the Agencies should allow banks to calculate the specific risk-weighting factor for a corporate debt position that is an exposure to a non-financial institution public company by referencing bond or CDS spreads. We note that the Agencies considered using bond spreads for assigning capital requirements for corporate debt positions and identified certain advantages to using such spreads.[23] However, the Agencies decided against relying on bond spreads, apparently because, according to the Proposed Rule, the bond market can occasionally misprice risk, and bond spreads can be relatively volatile.

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[16] *See* Proposed Rule, 76 Fed. Reg. at 79386.

[17] Our EB curves are updated several times each day, and are modeled on cross-validated inputs such as parsed quotes from dealer runs, IBOXX real-time composite price feeds, transaction prices reported through TRACE or Xtrakter, and end-of-day composites and contributor data.

[18] We currently produce 1,975 bond yield curves in U.S. dollars, and 2,816 in other currencies.

[19] Markit currently produces over 80 CDS sector curves on a daily basis, which represent the average CDS spreads by industry and rating category.

[20] A "liquid benchmark curve" is based on the yields of benchmark-sized bonds that are actively traded.

[21] Spread data for structured finance instruments is made available from various providers for a wide range of instruments and on a timely basis. Markit, for example, provides daily pricing for 65,000 non-agency RMBS, 125,000 Agency CMOs, 1mm Agency Passthroughs, 6,000 CMBS, 5,000 Consumer ABS, and 5,000 CLOs and CDOs.

[22] In a quiet market, implied volatility tends to be higher than historical volatility as market participants often price in an increased probability of larger market movements in the future. In contrast, in periods of turmoil, implied volatility tends to fall below historical volatility as the market is expected to calm at some point.

[23] *See* Proposed Rule, 76 Fed. Reg. at 79391-92.

2. Addressing potential Complications with Market-Based Measures of Creditworthiness

The Agencies highlighted several challenges to utilizing market-based measurements. We believe that those can largely be addressed as follows.

a. Volatility

We agree that the ability of market-based spreads to quickly reflect changes in perceived creditworthiness as newly available information is priced in on an ongoing basis also makes these measures relatively volatile. However, this characteristic can be addressed and therefore does not diminish the usefulness of these spreads. For example, banks could compute rolling averages of CDS or bond spreads in order to create a higher degree of stability. However, these averages should be carefully implemented. Specifically, we believe that the use of exponentially weighted averages might be advisable because this would assign a higher importance to recent spread movements that might reflect new fundamental information for the name. Additionally, we note that the Agencies should consider whether the weightings of such an average would be static or subject to change. One option might be to allow the Agencies to review weightings or time periods of the averages being accepted in order to reflect special market situations or avoid any undesired pro-cyclicality of these measures of creditworthiness.

b. Liquidity

Bond and CDS products have differing levels of liquidity, and the reliability of spread indications derived from them will differ between instruments and names as a result. We therefore believe that the aspects of liquidity and pricing reliability must also be taken into account when using market-based measures to quantify the creditworthiness of issuers, for example by putting less reliance on these inputs if the underlying instrument are very illiquid or contain a high level of pricing uncertainty.

c. Isolating Issuer-Specific Risk

The bond or CDS spread of an issuer will often be impacted by market-wide changes in risk appetite or the business cycle and therefore might occasionally represent more than merely the idiosyncratic risk of the issuer. We therefore believe that any reliance on market-based measures should be subject to normalization of the issuer spread against a suitable benchmark. For securitization positions, the Agencies discussed whether to normalize such spreads either by comparison to U.S. Treasuries or with the spread of a High Yield credit index.[24] For corporate issuers, the credit spread of an individual issuer could be compared to the spread of the appropriate traded High Yield or Investment Grade credit index. The resulting spread differential (instead of the absolute spread) should then be used as the basis for the calculation of issuer-specific capital requirements.

3. Conclusion

In summary, we believe that, to ensure that any approved alternatives to credit ratings are sufficiently robust and reliable, such alternatives should take a number of relevant inputs into account instead of relying on a single input. Further, we strongly believe that the Agencies should reconsider the use of market-based measures such as bond or CDS spreads as one of the inputs into producing alternatives to credit ratings.

We are open to discussing how the major perceived drawbacks of using market-based measures can be addressed. We are further open to discussing how quantitative techniques, such as factor analysis, can be

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[24] *See id.* at 79397.

employed to produce appropriately calibrated combinations of the relevant market-based and company-specific inputs as alternatives to ratings.

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We appreciate the opportunity to provide the Agencies with our comments on these proposed rules. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at marcus.schueler@markit.com.
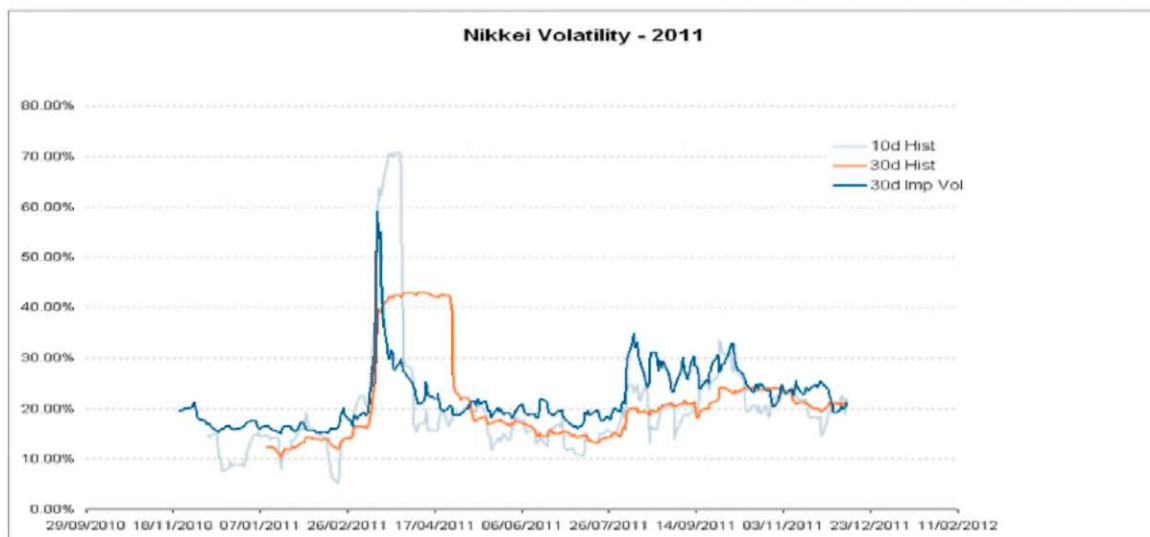
Sincerely,

Kevin Gould
President
Markit North America, Inc.

Appendix

I. Historical vs Implied Equity Volatility

Nikkei Volatility - 2011

II. Different Bond Yield Curves for an issuer

Example Co. Yield Curves