



Level 5
2 More London
Riverside
London
SE1 2AP

+44 20 7260 2000 Office
+44 20 7260 2001 Fax
www.markit.com

CESR
Sent via the CESR website

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CESR's Consultation paper on Fair value measurement and related disclosures of financial instruments in illiquid markets

Dear Sirs,

Markit welcomes the publication of CESR's consultation paper on 'Fair value Measurement in illiquid markets' and appreciates the opportunity to comment on it. Markit is a financial information services company with over 1,000 employees in Europe, North America and Asia. Over 1,000 financial institutions use our independent services to manage risk, improve operational efficiency and meet regulatory requirements. Given we are a provider of independent data and valuations, as well as the owner of the iTraxx and CDX indices, we are very much involved in a number of the issues that you touched upon in your consultation paper. We would hence like to provide you with the following response to your questions.

Question 1: Do you agree with CESR's view above regarding the distinction between active and non active markets for fair value measurement?

In our view, particularly in the current debate about valuation of illiquid instruments, it can be dangerous to rely too heavily on actual transactions to determine whether a market is 'active' and whether observable prices can be used with sufficient confidence. We therefore don't share the view that 'If observed transactions are no longer regularly occurring, even if the bid-ask prices might be available, the market should not be considered as active anymore'. Consistent with views voiced by the IIF in its Final Report on Market Best Practices, we are of the opinion that in many instances a properly calibrated model or strong consensus data can provide a much better indication of the fair value of a financial instrument than single, isolated transactions. Also, a limited number of transactions alone can not be sufficient to call a market 'active', while broad based quoting of bid/ask spreads and/or a significant number of contributors of end-of-day prices can provide a much more accurate reflection of the liquidity of a financial instrument. We therefore propose taking different measures of 'liquidity' into account to determine whether a product is regarded 'active'.

Based on our experience in providing price verification services as well as on discussions with market participants, it is obvious to us, that most transactional data should not be used without applying critical judgement in order to decide on its relevance. The interpretation required for transactional data is far from straightforward and has to take into account a range of different factors, such as the timing of the trade, whether it was an odd-lot or big sized trade, whether it was an axe, or a distressed sale. Experience has shown, that even transaction prices for exchange traded derivatives often cannot be regarded as a proper reflection of fair value without further examination, be it because of the limited number of transactions, particularly in longer maturities or for out of the money strikes, or the impact of technical factors such as the way how a closing price is calculated.

Markit ensures the data quality of its pricing services through the rigorous application of cleaning algorithms. Based on tests that identify stale data, flat curves, lags, recycling, and outliers we will, depending on the asset class, reject between 20% and 60% of the data we have received from our contributors. The quality of published data is measured through the use of 'Data Quality Ratings' that take into account the number of accepted contributors to a consensus price, the 'freshness' of the data, as well as the range of accepted contributions. Data Quality Ratings represent a good proxy for the liquidity of a specific instrument, and could be used in addition to or as an alternative to the number of transactions to determine whether a name is 'active'. There will be many instances where for example data for a specific Credit Default Swap (CDS) receives a very high Data Quality Rating, while the number of actual transactions taking place for this name might be very limited reflecting purely the lack of interest from market participants in trading it. The proposed definition of 'active' would fail to take these situations into account where names are liquid but just haven't traded, and hence wouldn't allow the usage of observable quotes despite the fact that a product is 'liquid' with a large number of observable prices being available.

We do fully agree with CESR's recommendation that the reliability of prices should be tested by checking consistency with other sources. Our consensus data is now increasingly validated through the use of bid/ask quotes from market makers and transactional data where available, to achieve a level of data quality that surpasses regular, unchecked transactional data.

In summary, we are of the view that market prices, whether it is dealer quotes or consensus prices, often surpass the quality of pricing information from actual transactions, and their usage should be accepted even in situations where no transactions have taken place. We would hence propose the following ranking of price quality to define 'active', where the first three levels should be regarded as 'active' markets:

- Transaction prices from regular and frequent transactions, when there is also broad based quoting
- Consensus prices based on a sufficient number of contributors, calibrated against transaction prices from infrequent trading
- Consensus pricing based on a sufficient number of contributors
- Modelled prices, if neither transactions nor broad based quoting or consensus pricing are available

Question 2: Do you agree with CESR's view above regarding inputs to valuation techniques for financial instruments in illiquid markets?

Markit strongly supports CESR's view, that 'due consideration must be given to the particular facts and circumstances when using indices to price ABS or CDO's. We are actually of the opinion, that caution is advised whenever an index is used to value products that are not exactly the same, not only in the area of structured finance but also for leveraged loans or senior unsecured corporate credit exposure.

The Markit CDX and iTraxx credit indices were created to become liquid products that could be traded even in challenging market conditions. As a matter of fact, in the recent period of severe market stress, the major credit indices have not only maintained liquidity but consistently represented the bulk of the trading activity in the credit markets. As the history of credit index development has demonstrated, one of the crucial ingredients of a liquid index product is that it should be based on liquid underlyings. Therefore, the tradable credit indices won't necessarily be a broad representation of the overall market, nor are they intended to reflect the performance of illiquid or bespoke products. If indices had been created to represent these exposures, they probably wouldn't be liquid, wouldn't trade, and hence could not be used as generic hedging or trading tool. Their liquidity, if they ever became liquid in the first place, would almost certainly dry up when it was needed the most.

Also, the market crisis highlighted the potential magnitude of basis risks between different formats of credit exposure. Credit index products trade in their own right and demand/supply dynamics other than fair value can drive their pricing. In periods of market stress, significant differences have arisen between the trading level of an index and the value implied by its underlying exposures, in addition to the differences that can arise between synthetic single name exposures and the comparable cash products. As the recent experience has shown, both of these relationships can deviate from each other for extended time periods without necessarily arbitrage activity forcing them quickly back in line again. Using CDS based indices to value or hedge cash instruments will always be exposed to the described basis risks that proved to be very significant in times of market stress.

While the ABX indices provided one of the only points of liquidity in the market throughout the crisis, and their importance as generic hedging tools has been widely recognized, we completely agree that care should be applied when these indices are used as a basis for ABS/CDO valuations, and adjustments must be made to reflect the actual quality of collateral backing the security, as well as the characteristics of the security itself. There are four vintages of ABX.HE, and users should take care to apply the correct one in valuations, while additionally there is a wide range of different qualities for individual subprime RMBS. ABX.HE was not constructed to be representative of the entire market, and it is generally also less suited to be a proxy for CDO valuations. The BBB ABX.HE index for example should not be used as a proxy for the BBB tranche of an ABS CDO. While TABX.HE might be regarded as a better proxy, it only attracts limited trading volume and is hence probably not reliable enough as a valuation tool.

In response to your 2nd technical point on ABX in paragraph 38, we would like to bring to your attention that a Penultimate AAA index, called ABX.HE.PENAAA, was recently launched to provide an additional point of reference at the AAA level. While the original AAA index does indeed reference the longest dated AAA tranche, the PEN.AAA references the penultimate AAA tranche, ie. the next-to-last cashflow Triple-A bonds. Many institutions have started using this index as an additional point of comparison for AAA bonds. Furthermore, related to CESR's comments on the use of ABX.HE for different vintages of loans, it might be useful to point out, that the launch of additional ABX.HE indices referencing prior vintages is currently under consideration, which would further expand the coverage of the ABX indices and increase market transparency.

Markit is open to engaging in a constructive dialogue about the application of our indices and also the potential to create additional indices, that could help market participants to gain visibility and tradability in other areas of the credit market. However, as a general principle the indices should always be constructed in a way that allows them to be tradable and generate sufficient liquidity.

We hope you will find our comments useful. Please don't hesitate to contact us if you require any additional information.

Kind regards,



Tom McNerney
Managing Director



Marcus Schuler
Managing Director
Regulatory Affairs