



Level 5  
2 More London Riverside  
London  
SE1 2AP

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

Financial Services Authority  
Via email to [liquidity.policy@fsa.gov.uk](mailto:liquidity.policy@fsa.gov.uk)

## Consultation Paper on *Strengthening Liquidity Standards*

London, January 28<sup>th</sup>, 2009

Dear Sirs,

Markit welcomes the publication of the FSA's Consultation Paper on *Strengthening Liquidity Standards* and we appreciate the opportunity to provide you with our comments.

Markit is a London-based 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 markets with "fair value" levels in over-the-counter derivatives. Today, all major banks, broker dealers and commodities traders use Markit's services to assist them in the process of determining the fair value of their positions across asset classes and different formats of products. Many of them will incorporate Markit's independent price information in the preparation of their financial accounts.

Over the years, Markit has accumulated a significant amount of expertise not only in the pricing of financial products but also in the measurement of their liquidity and credit quality, and we therefore feel well placed to comment on the issues you raised regarding the Liquidity Buffer in particular. Please find below our responses to some of the questions you asked in your consultation paper.

## **Introductory Comments**

We are generally supportive of your new liquidity regime, as we would expect a strong liquidity regulation to enhance the competitiveness of the UK financial services sector in the long run. Whilst we are not in a position to comment on the chapters that define how banks should manage their funding sources and their overall liquidity position, we felt compelled to provide you with our comments on your proposals relating to the composition of the Liquidity Buffer, i.e. Question 57 specifically.

## **Issues related to the Definition of the Liquidity Buffer**

According to your proposal, the Individual Liquidity Guidance (ILG) will define a minimum amount of high quality liquidity resources that the firm is expected to hold, i.e. its Liquidity Buffer. Whilst we sympathise with your call to firms to increase both the amount and the quality of liquid assets going forward, we do not feel that sufficient effort has gone into ensuring that they really are of high quality and highly liquid. Instead, your proposal seems to rely on old-fashioned rules such as “government bonds are safe and very liquid”.

We are of the view that more diligence has to be applied to ensure that the Liquidity Buffer only contains assets that are only of the highest quality and liquidity, instead of simply asking for “highly liquid, high-quality government debt instruments, rated at least Aa3”. In our opinion, obliging firms to submit a profile of marketable assets, split by asset class, maturity, and currency, does little to control the actual quality or liquidity of these assets, neither does the observation that the behaviour of marketable assets will depend amongst others on “market-related” factors address the relevant issues.

While we do not necessarily object to the choice of government bonds as the basis of the Liquidity Buffer per se, we do not think that a static concept that disregards the actual liquidity of bonds and uses a credit rating to measure quality is appropriate. In contrast we are of the opinion that a dynamic, quantitative measurement of liquidity and quality on an instrument specific basis is required to achieve your stated objectives. We would therefore advocate the use of a market-based approach which promises to be much more accurate and reliable for your purposes.

## **Measuring Quality and Liquidity of Financial Products**

Acceptance of a product for inclusion in the Liquidity Buffer should reflect the ability of the firm to liquidate its investment close to the current market price in a reasonable timeframe. This expectation should be based on an informed and thoughtful judgement of the product’s level of actual and measured credit risk, its liquidity, and its volatility. To minimise the burden on firms and regulators when deciding on eligibility, it is advisable to check whether these characteristics are quantifiable, whether they can be easily measured and whether there is a ready source for the relevant information. Whilst, most importantly, these alternative provisions should be an accurate reflection of the risk parameters that they are aiming to measure, they should also be forward-looking, objective, observable, easy to source and simple to compute. Only this combination of attributes will maximise market transparency and minimise the cost and potential for uncertainty.

Fortunately the financial markets have evolved to provide independent indications of all three required product characteristics. Market-based measures are easily observable and transparent, updated frequently, and built on both the expectations and actual transactions

of all relevant market participants. The use of a large and complementary set of relevant data to inform the measures of credit risk, liquidity and volatility of a financial product presents material advantages. While some additional research might be helpful in forming a consensus judgement as to which market-based measures are best suited as proxies for these risk properties, the following is a summary of our thoughts on these topics.

### **Measuring Quality**

At a time when most regulators have identified “undue reliance” on credit ratings as a major cause of the current crisis and consider removing references to ratings from their own rules, the FSA’s plan to reference credit ratings in a new rule certainly comes as a surprise. Generally, we find it difficult to understand why you consider using a static approach to ensure sufficient quality of the assets, given that Credit Default Swaps (CDS) trade for most high grade sovereigns and many of those trade at levels reflecting increased concerns about their “quality”. That said we are of the view that a dynamic and objective market-based approach to measure “quality” is needed.

In our view, CDS constitute a more reliable, accurate and dynamic measure of default risk of an entity compared to the one derived from the bond spread or credit ratings. CDS incorporate all available information processed by all relevant market participants, and provide a market clearing price for credit risk in the form of CDS spreads on most names on an almost continuous basis. Also it is important to note that the CDS market has managed to maintain its liquidity throughout the entire crisis which cannot be said for many other financial markets. Monthly CDS volumes in the last quarter of 2008 actually surpassed the record levels observed in mid 2007 (based on activity by the largest dealers, please see the Quarterly Metrics Report, available on [www.markit.com](http://www.markit.com), for further details). Whilst the approach of using actual credit spreads to measure credit risk has been implemented by a number of market participants and discussed in academic literature to a certain extent, further research might be helpful in determining how accurate the predictive quality of credit spreads is, how credit spread information could be used in practice, and also what actual measure of the credit spread should ideally be used to avoid potential undesired side effects such as pro-cyclicality or elevated volatility.

Markit collects millions of price points on financial products from the market makers every single day, ranging from bonds, CDS, and ABS to exotic derivatives across all asset classes. We perform a number of cleansing algorithms, such as testing for stale data, flat curves, or outliers on the contributions that we receive, causing us to reject up to 60% of the data for some asset classes. On that basis, we compute high quality consensus pricing data which is just the simple average of the accepted contributions. For CDS we currently provide spread curves for approximately 3,300 entity tiers every day, with histories for many of them available from 2001. Furthermore we capture current bid/offer spreads for many names through dealer quotes, and compute intraday credit spread curves as an amalgamation of end of day contributions and quotes feeds. In the area of sovereign CDS we publish daily spread curves for 27 of the relevant high grade sovereigns, with CDS referencing Germany, France and the US trading in the area of 60bp p.a. for the five-year maturity, while the UK, Austria, and Italy all currently trade north of 100bp p.a. in spread.

Measuring the “quality” of the government bonds that are considered for the inclusion in the Liquidity Buffer could easily be performed based on these credit spreads. However, using simply the current CDS spread as a measure of credit risk might introduce an undesired level of volatility and runs the risk of occasionally being exposed to technical pressures. It

might therefore make sense to compute rolling averages of credit spreads to produce credit risk measures with a higher stability. That said there probably needs to be a discussion about the exact nature of the averages, where the use of exponentially weighted averages might be advisable to assign a higher importance to recent spread movements that incorporate relevant new fundamental information for the name. Also, it might be worth considering whether the weightings of such an average should be static or whether they could change. One option might be to allow regulatory bodies to review and potentially change the weightings or time periods of the averages being accepted in order to reflect special market situations or avoid any undesired pro-cyclicality of these credit risk measures.

The approach of using CDS spreads to perform a “quality test” and determine the eligibility of government bonds of a specific country to the Liquidity Buffer would also hugely simplify the ongoing task of monitoring the development of “quality” on a timely basis and at limited cost. Instead of burdening regulators and investors with the obligation of ensuring that they are becoming aware of any information which suggests that some government bonds might not be of “highest quality” anymore, investors could simply use the power of the markets that perform the task of checking for news and incorporating it into spreads anyway, on a constant basis and at no additional cost.

Besides using sovereign CDS spreads to measure the quality of the related government bonds and their volatility, another relevant factor that should be taken into account could be based on the same data set, where likewise the major challenge would not really be the data input, but rather the exact way in which the measure of volatility should be calculated.

To summarise, we are of the view that a decision to accept the use of market-sourced credit spreads as a measure of credit risk and volatility would be beneficial to market participants as well as to regulators. Such a market-based measure could be used instead of or to support the use of credit ratings.

## **Measuring Liquidity**

We are of the view that using the simple, static assumption that government bonds are liquid will not be sufficient to ensure real liquidity of the Liquidity Buffer, given that liquidity can differ significantly between bonds of the same issuer and in the recent past even segments of the government bond markets have become dysfunctional.

As you stated in your consultation paper, the desired measure of liquidity of a financial product reflects the firm’s ability to sell it in the market within a certain time period at a level close to the current price, a characteristic which could be called its “prospective liquidity”. The goal for the purpose of the Liquidity Buffer must therefore be to quantify this prospective liquidity for potential investments in an objective and accurate way; additionally the measure should be observable, dynamically updated, forward looking, and available for the majority of the relevant bonds.

Unfortunately, liquidity is not only an important risk property of financial products, but it is also notoriously hard to measure. Whilst some market participants would advocate using actual trading activity in the past to measure potential liquidity in the future, the usage of transactional volumes is exposed to a number of theoretical as well as practical issues, making them rather ill suited for the desired purpose:



- Daily trading activity can only ever be observed for a very limited part of the universe of all tradable products, and only for a subset of these are trading volumes actually publicly available. Liquidity measures derived from actual trading volumes can therefore only be computed for a small number of products, and could not really serve as the benchmark measure for liquidity for the population of the entire market.
- The fact that a product has not traded in the recent past should not be regarded as proof that it is not liquid, and the investor could not sell it quickly if he wanted to. Some products that might not trade today because there just is not enough interest in them currently are potentially very liquid if you want to trade. For example, think of an off-the-run government bond that is still quoted by all market makers but simply does not attract any trading volume anymore since it has become off-the-run. Experience has shown that such a bond can suddenly attract a lot of trading activity if it became the cheapest-to-deliver bond into the futures contract or if it was recommended in a number of research notes.
- Finally, as the recent past has shown, the actual turnover of a product can dry up suddenly depending on the market situation, and past turnover has therefore proved not to be a consistent and accurate predictor of availability of liquidity in the future. Any static measures of liquidity will fail to take changing market conditions into account.

Given the described issues it is fair to say that, while it does have value as additional input, transactional data alone will not suffice to measure future liquidity for the whole universe of relevant products. Fortunately, there exists a much more reliable and appropriate way to measure the expected future liquidity of financial products: the Data Quality Rating, a parameter that we have been computing and publishing for many years based on the variety of daily market data contributions we receive.

## Data Quality Ratings

Markit's Data Quality Ratings can be used as a good proxy for the prospective liquidity of a product, given that they are derived from the following input parameters:

- The number of accepted pricing contributors for the product, i.e. the ones that are accepted after rejecting many others based on our cleaning algorithms;
- The range of accepted contributions, i.e. the difference between the highest and the lowest accepted prices; and
- The freshness of the data, i.e. how recently the contributions were last updated by the contributors.

All else being equal, a higher number of accepted contributors, a narrower range of accepted contributions, and a greater freshness of the data will lead to a higher Data Quality Rating. Importantly, it will also signal a higher prospective liquidity for this product, as more market makers will provide prices when needed, there is little disagreement between them about the current price, which implies that a tight bid/offer spread for decent size should be expected, and with dealers frequently updating their prices the investor will be able to receive a number of tradable prices quickly. If all of these factors are in place, they signal that the firm can liquidate a position quickly and close to the current price when needed.

Data Quality Ratings are dynamic as they will reflect changes in the underlying variables on a daily basis. Please note that a detailed description of the computation of Markit's Data Quality Ratings is available on request.

In addition to the three inputs mentioned above, we are in the process of integrating quotes data, i.e. bid/offer runs that we receive from the market makers, as well as transactional data, where we have it, into this liquidity measurement concept. One way of doing so will be to give a higher liquidity rating to names that appear on a number of quotes runs every day, as it signals that this name is actively traded by multiple dealers. We are also working on ways to take the quoted bid/offer into account, with a tighter bid/offer justifying a higher Data Quality Rating and expected liquidity.

Based on our current data set, we publish Data Quality Ratings for more than 780 of the government bonds that are relevant for the Liquidity Buffer, classifying them into five different categories of data quality / liquidity. For an additional 360 government bonds we do not receive a sufficient number of contributions to compute a Data Quality Rating, which implies that they should be expected to be less liquid than the rated ones. Using the liquidity measures as described above will provide regulators and investors alike with an accurate, dynamic, and transparent measure of the prospective liquidity of these government bonds.

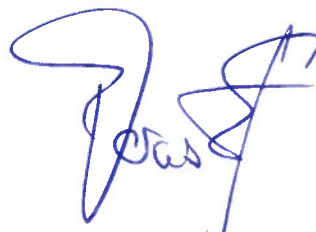
All said, we advocate the use of Liquidity Ratings in combination with market-based measures of quality and volatility in order to provide a reliable, unbiased, and dynamic measurement of the eligibility of government bonds for the Liquidity Buffer on an instrument by instrument basis. Markit is open to engaging in a constructive dialogue with regulatory bodies and academics interested in how to measure the risk properties of financial products based on a range of market sourced inputs and how to develop and refine the definition of Data Quality Ratings to make them most useful for your purposes.

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,



Tom McNerney  
Managing Director  
Head of Data and Analytics  
[tom.mcnerney@markit.com](mailto:tom.mcnerney@markit.com)



Marcus Schüler  
Managing Director  
Head of Regulatory Affairs  
[marcus.schueler@markit.com](mailto:marcus.schueler@markit.com)