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07 September 2012

The Wheatley Review
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Submitted via: wheatleyreview@hmtreasury.gsi.gov.uk

Re: The Wheatley Review of LIBOR: initial discussion paper

Dear Sir/Madam:

Markit[1] is pleased to submit the following comments to HM Treasury (the "***Treasury***") in response to *The Wheatley Review of LIBOR: initial discussion paper* (the "***Initial Discussion Paper***").

Introduction

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics and related services across regions, asset classes and financial instruments. Our products and services are used by a large number of market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities.

For many years we have operated pricing and valuation services for a large variety of financial products with a particular focus on those that do not trade on a continuous basis and are hard-to-value. Our services, which often also take into account daily contributions from market makers, will provide, for example, pricing for OTC derivatives and for cash instruments across asset classes that our clients will use for their internal valuation procedures or risk management. Over many years we have developed and refined the processes that we use to determine which contributors should be included in a service, which individual contributions to accept or reject, and how to produce a reliable price indication on the basis of the contributions that we received and the wealth of other data we use to corroborate the contributions. We have also gathered extensive experience in designing and operating auction procedures that serve to determine market-clearing prices, for example for the settlement of outstanding transactions in credit default swaps ("***CDS***") following a credit event.[2] Based on this experience we are pleased to provide the Review team with our views on the Initial Discussion Paper.

Comments

For a benchmark rate as important as LIBOR, given that it is referenced in and determines the cash flows of contracts with a notional outstanding value of "at least USD 300 trillion", it is essential to restore market and public confidence as quickly as possible. We therefore welcome the publication of the Treasury's Initial Discussion Paper and we appreciate the opportunity to provide you with our comments. Specifically, we believe that market confidence in LIBOR will depend on applying several enhancements to the current process which could include more transparent rules on submission, the use of auctions and transaction

[1] Markit is a financial information services company with over 2,700 employees in Europe, North America, 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] The Markit Auction platform provides comprehensive auction and auction management services across asset classes. Since 2005, Markit has been responsible or jointly responsible for administering more than 130 auctions worldwide. The Markit Auction Platform was originally developed for credit event auctions in conjunction with the International Swaps and Derivatives Association and Creditex. Credit event auctions are the process for valuing credit derivatives after a default. Today, the platform is compatible with a full array of financial assets, as well as with the unique requirements of multiple types of environmental credits, including emission permits and water quality credits.

data, design of appropriate incentives for the submission of accurate data, and the use of rigorous data cleansing procedures.

1. Issues and challenges

LIBOR rate fixings are intended to represent the term structure of short-term prime credit exposure. Ideally, they would be based upon an observable and liquid underlying market. However, the global short-term bank lending markets have become illiquid and inhomogeneous over the last couple of years. Today, most of the activity in unsecured term inter-bank lending that LIBOR should be based upon has been replaced by other forms of financing. Therefore, a reliable LIBOR fixing cannot be produced solely based on transactions, and the submissions of contributors to the LIBOR fixing will often have to be based on their judgment as opposed to observable data.[3]

We believe that this situation presents policy makers and market participants that are trying to address "the LIBOR problem" with several fundamental challenges:

- Any individual steps that are taken in isolation to strengthen the LIBOR fixing mechanism are unlikely to fully compensate for the simple lack of liquidity and transactions in the underlying market.
- Alternative rates that represent more liquid underlying markets reference, implicitly or explicitly, government rather than corporate credit and/or overnight rather than term lending. They will therefore, by their very nature, not be representative of prime term corporate credit rates, making any attempt to transfer existing transactions to such a new benchmark technically difficult and, arguably, undesirable.

That said, we base our below recommendations on the following assumptions:

- A voluntary novation of existing LIBOR-referencing transactions to a different benchmark is extremely unlikely, as participants would find it impossible to agree on the basis between the new benchmark rate and LIBOR. On the other hand, a compulsory novation is unthinkable, as it is likely to result in creating large profits or losses for some participants. As any replacement of LIBOR references in the many contracts that exist today would be complex and potentially disruptive, we believe that it cannot really be considered as a practical option. We therefore assume that LIBOR will continue to exist and that current efforts must focus on identifying effective measures to strengthen it.[4]
- We believe it is unlikely that the use of a single measure in isolation would improve and strengthen the LIBOR fixing sufficiently [5] and we therefore recommend for a number of actions to be implemented simultaneously. Improvements that should be considered in this context include the systematic collection and use of transaction data, the use of auction mechanisms, expert day-to-day analysis of submissions, improved incentives for contributors, and a strengthened governance structure as well as regulatory oversight.[6]
- However, in addition to strengthening the existing LIBOR fixing, regulators and market participants should also promote the use of alternative fixings that are based on more liquid underlying markets.[7] Such benchmarks already trade in the swap markets and could also be used as reference for other markets. Over time they could naturally replace LIBOR by attrition, which seems much preferable to a forced replacement.

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[3] Be it individually or collectively, deliberately or accidently.

[4] Furthermore, if at some point in the future inter-bank credit markets regained their liquidity, LIBOR could become a much more reliable benchmark again and its destruction would then seem precipitate. In response to Box 4.A Consultation question: "Should an alternative benchmark fully replace LIBOR, or should it substitute for LIBOR in particular circumstances?"

[5] In response to Box 4.A Consultation question: "Are there credible alternative benchmarks that could replace LIBOR'S role in the financial markets?

[6] In response to Box 3.A Consultation question: "Can LIBOR be strengthened in such a way that it can remain a credible benchmark?

[7] In response to Box 4.A Consultation question: "What role should authorities play in developing and promoting alternatives to LIBOR?"

2. Recommendations

We believe that making some small changes to LIBOR in isolation, such as just enlarging the panel sizes, is likely to be ineffective. On the other hand, forcing the entire market to adopt an alternative benchmark would be highly disruptive, operationally complex and would probably create arbitrage opportunities for some and losses for others. We therefore believe that one should consider the use of a number of carefully calibrated measures in combination in order to significantly strengthen the robustness of LIBOR rate fixings:

a) Participation

- We agree in principle that increasing the number of contributors to a benchmark fixing could improve its quality. Specifically, we believe that the groups of contributors to the respective LIBOR fixings should be broadened up to the point where all active market participants take part. However, our experience has shown that, at the same time, one must avoid being overly inclusive and adding submitters beyond this group. This is because the inclusion of "non-experts" will only create unnecessary noise and result in reducing the quality of the fixing, sometimes significantly so.
- We believe that one should consider establishing appropriate economic incentives for potential contributors to a benchmark fixing to encourage participation. Relevant measures could be, for example, the use of give-and-get provisions, different levels of detail or delays for the data,[8] and/or the design of a licensing regime. In the latter framework, parties that hold positions in financial instruments that reference LIBOR would pay a fee for their use of the LIBOR fixings, while contributors would be compensated for their efforts by receiving a portion of these licensing fees.
- However, the Review team should take into account that material disincentives exist for contributing to benchmark fixings such as LIBOR as recent experience has demonstrated the significance of liabilities that contributors might be exposed to.[9] Therefore, in addition to establishing appropriate economic incentives that could encourage contributions to the LIBOR fixing, one should also consider making it mandatory for active market participants. We believe that the decision whether a firm is an "active market participant" and should hence be obliged to contribute to the LIBOR fixing should be, to the extent possible, based on objective factors such as transaction volumes.

b) Data submission and cleansing

- Submissions
    - We believe that the actual data submission and collection should be as automated, efficient, and objective as possible. The individuals that are submitting should be properly segregated from trading activity, the submission rules should be tightly controlled, and the submission process itself should be fully automated and auditable.
    - A thorough analysis of all individual submissions should be performed by a qualified, independent third party upon receipt of the data. This analysis should be designed to detect any abnormal or suspicious patterns early on and would form the basis for the acceptance, challenge, or rejection of individual contributions. It should employ not only sophisticated, automated data cleansing techniques but also ad-hoc analysis by financial market data experts.
- Generate and/or use additional relevant data
    - Transaction data
        - We agree that a broader use of transaction data could be helpful to improve the quality of the LIBOR fixing. To achieve this objective, we believe that mechanisms could be established to systematically collect relevant transaction data and make it available when

[8] Such model would work based on the principle that only contributors to the fixing, or that only those contributors whose contributions have been accepted, will have access to the detailed dataset.

[9] Importantly, this issue will represent a challenge not only in relation to the contributors, but it could also discourage any qualified third party from being involved in the determination of the LIBOR fixing. We therefore urge the Review team to consider how the potential liabilities that third parties that are involved in the LIBOR fixing can be addressed.

and where appropriate. We believe that the experience gathered in relation to the creation of Trade Repositories in the OTC derivatives markets over the last couple of years might provide helpful guidance in this respect.

- Auctions
  - To create additional, reliable data points regular auctions could be designed and operated, where needed, similar to what has been established in other financial markets in recent years.[10] Such auctions should result in creating "tradable" or "traded" fixings at least for some currencies or maturities. The auction procedures should be designed with a high degree of automation and should include the use of appropriate rules and incentives to ensure the accuracy of the individual contributions. However, while forcing contributed prices to be executable within a regime of fixed bid/ask spreads often produces fairly reliable results, one must note that factors such as credit lines might limit the ability to transact or that trade sizes may sometimes not be sufficiently large to effectively secure the quality of the submissions.
- Other relevant data
  - We also believe that data that is referencing other, but somehow related financial products should be used more extensively. This data could include, for example, short-dated CDS spreads of the contributing firms that will be useful for the validation of their individual contributions to LIBOR.

- The actual fixing methodology
  - We believe that more sophisticated methodologies than a simple "top and tail" should be used to decide whether an individual contribution to LIBOR should be rejected or accepted. These techniques should include, for example, the corroboration with transaction data, with other submissions, as well as with other relevant data points.
  - Interpolation (but not extrapolation) techniques should be employed to estimate or validate the less liquid points of the term structure where needed and appropriate. Interpolation could be performed not only between maturities, but also between dates and with reference to moves in other markets such as interest rate and FX swaps. Any models or financial engineering techniques used in constructing the yield curves should be transparent.
  - The use of data aggregation techniques that are not just simple averages should also be considered. For example, it might be appropriate to use weightings that reflect the difference in relevance between the various contributions rather than an equal weighted average.

c) Transparency

- An appropriate level of transparency must be established around the LIBOR fixing and the contributions that it is based upon in order to restore public confidence. Importantly, one should aim to create the *appropriate* level of transparency and not just *maximum* transparency, as the latter could easily lead to detrimental results. Specifically, while the contribution data points and the list of contributors should be published, we believe that individual contributions should not be labelled to prevent the "signalling" driven contributions that occurred in the past. However, the full labelled data sets should be available to the relevant regulatory authorities and governing bodies.

d) Governance and regulatory oversight

[10] Markit and Creditex have jointly acted as administrators of CDS auctions since their inception in June 2005. Credit Event Auction is an industry standard mechanism designed to ease the settlement of credit derivative trades following a credit event. The auction process determines the cash settlement price of a CDS, with the compensation received by the protection buyer based on the final agreed auction price. The Auction was based on the iTraxx Europe weekly fixings methodology developed by Creditex and Markit, then refined by market participant groups and ISDA to become what it is today. ISDA updated their standard definitions to incorporate Auctions in April 2009 (Big Bang Protocol). Auction protocols are available on the ISDA website at www.isda.org and the over 130 auction results are available on www.creditfixings.com

- The governance of the LIBOR fixing should be transparent and create more accountability towards regulators and the public as opposed to just market participants. This could include a panel that consists of a diverse range of stakeholders, including users of LIBOR, as well as regulatory authorities. Minutes of panel meetings, names of the members, and voting rules should be made publicly available.
- The process of the LIBOR fixing, including contributing to LIBOR, should be a regulated process, instead of a self-policing one. However, we believe that further discussions are required to determine what exactly the involvement of regulatory authorities in this process should be, and whether it should include any intervention in the daily fixing process, reporting of detailed information to them, or it would consist mostly of creating a generic rule framework to govern it.

3. Alternatives to LIBOR[11]

When identifying suitable alternatives to LIBOR, those that are based on liquid underlying markets may be the most suitable, as it will ensure that any fixing can be based on transaction data instead of having to rely on panelists' unsubstantiated opinions.[12] That said, we believe that rate-fixes based on the repo[13] or on the OIS[14] markets could indeed constitute a basis for alternative rate fixings. However, regulatory authorities should carefully consider the characteristics of these markets before making any further decisions.[15,16]

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Markit appreciates the opportunity to comment on HM Treasury's Initial Discussion Paper: *The Wheatley Review of LIBOR.* We would be happy to elaborate or further discuss any of the points addressed above. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at marcus.schueler@markit.com.

Yours sincerely

Kevin Gould
President
Markit North America, Inc.

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[11] In response to Box 4.A Consultation question: "Are there credible alternative benchmarks that could replace LIBOR's role in the financial market?"
[12] In addition, any above recommendations in relation to strengthening the existing LIBOR fixing should also be taken into account.
[13] As a deep and liquid repo market has existed in a number of currencies for many years, repo rates have been suggested as an alternative to LIBOR rates. However, while a degree of term structure has also developed in some repo markets, volumes are heavily weighted towards overnight lending. More importantly and similar to OIS, repo rates do not represent prime term corporate credit. This generally calls into question the usefulness of repo rates as a replacement for LIBOR.
[14] OIS (Overnight Indexed Swap) rates are based on interest rate swaps where the floating rate is equal to the geometric average of an overnight index over the payment period. Interestingly, a number of market participants have started using OIS rates instead of LIBOR in the recent past to construct the yield curves that they use to discount cash flows of derivative transactions. This is because they believe that OIS rates more accurately reflect their funding costs and the rates that are appropriate for cash collateral that is held under derivative collateral agreements.
[15] OIS rate fixes are averages of actual transactions in the overnight markets, and many of them are already well used as reference rates for swaps (e.g. EONIA, SONIA, Fed Funds). However, a 6-month average of an overnight borrowing rate is not the same thing as a 6-month borrowing rate: the latter has a much higher element of credit risk inherent in it. 3 or 6 month LIBOR is a more realistic proxy for a rate paid by a bank or corporate rolling over its debt on a 3-6 month frequency than a compounded and averaged OIS rate is. Therefore, a non-zero and volatile basis exists between OIS and LIBOR rates, as they represent different types of exposures. The LIBOR-OIS spread has historically hovered around 10 basis points. However, in the midst of the financial crisis of 2007–2010, the spread spiked to an all-time high of 364 basis points in October 2008.
[16] While a degree of term structure has also developed in some repo markets, volumes are heavily weighted towards overnight lending. More importantly and similar to OIS, repo rates do not represent prime term corporate credit. This generally calls into question the usefulness of repo rates as a replacement for LIBOR.