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Market Infrastructure and Policy
Financial Services Authority
25 The North Colonnade Canary Wharf
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Submitted via: cp12_36@fsa.gov.uk

Re: The regulation and supervision of benchmarks

Dear Sir/Madam:

Markit[1] is pleased to submit the following comments to the Financial Services Authority (the "***FSA***") in response to its Discussion Paper on *The regulation and supervision of benchmarks,* specifically *Chapter 4 Broader participation in LIBOR: a discussion* (the "***Discussion Paper***" or the "***DP***").[2]

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. Markit is an index provider for various index families across regions and asset classes, including bonds, credit default swaps and loans. We administer and publish the composition of all Markit indices and also calculate the levels of the Markit iBoxx suite of bond indices and other third-party indices.

Markit has been actively and constructively engaged in the discussion regarding regulatory reform of the financial markets. We regularly provide regulatory authorities with our insights on current market practice, for example in relation to valuation methodologies, the provision of scenario analysis, and the use of reliable and secure means to provide daily marks. We have also advised regulatory bodies on potential approaches to enable timely and cost-effective implementation of newly established requirements, for example through the use of multi-layered phase-in or by providing participants with a choice of means for satisfying regulatory requirements. Over the last two years, we have submitted over 40 comment letters to regulatory authorities around the world, and participated in numerous roundtables. In the context of the discussion regarding the regulation of benchmarks and indices we have submitted responses to *The Wheatley Review,*[3] the FSA's *Consultation Paper on the regulation and supervision of benchmarks*,[4] the European Commission's *Consultation Document on the Regulation of Indices*[5] as well as to IOSCO's *Consultation Report on Financial Benchmarks.*[6]

[1] Markit is a financial information services company with over 2,900 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] FSA: The regulation and supervision of benchmarks. December 2012.
[3] The Wheatley Review of LIBOR: initial discussion paper. Markit letter to the HMT regarding the initial discussion paper (07 September 2012) *available* here.
[4] FSA Consultation Paper: The regulation and supervision of benchmarks. Markit letter to the FSA regarding consultation paper (16 January 2013) *available* here.
[5] Consultation Document on the Regulation of Indices: A Possible Framework for the Regulation of the Production and use of Indices serving as Benchmarks in Financial and other Contracts. Markit letter to the European Commission regarding the consultation document (29 November 2012) *available* here.
[6] IOSCO Consultation Report: Financial Benchmarks. January 2013.

Executive Summary

The Wheatley Review concluded that global markets would benefit from the continuing participation of major firms in the LIBOR panels and that market integrity could be undermined if the firms that are currently submitting to LIBOR ("***Submitters***") were to stop making contributions.[7] We welcome the FSA's initiative to discuss the relevant issues in relation to the panel membership for LIBOR and its commitment for this discussion to remain an industry-led process. On this basis we encourage the FSA to actively work with the industry to identify and agree upon the appropriate criteria to determine panel membership for LIBOR. We believe that such approach will increase the likelihood that the right firms will contribute to each of the various LIBOR panels.

We appreciate the opportunity to provide the FSA with our comments on the Discussion Paper. Below we recommend specific considerations for the FSA to take into account when determining panel membership and panel size.

DP1: Do you agree that the specific indicators and methodology we have identified adequately capture those institutions that will maintain the integrity of the LIBOR rates?

We generally support the FSA's objective of identifying appropriate methodologies and sufficiently objective criteria that can serve as a basis for the determination of which firms it would expect to be members of the various LIBOR panels.[8] The FSA proposed that such criteria should be high level, referenced to easily defined data that is publically available from relatively stable sources and unlikely to experience significant movements on a short–term basis. Furthermore, it required this data to be easy to audit and reported in a similar way across all relevant jurisdictions. On that basis the FSA defined the three categories footprint, lending/borrowing, and expertise[9] that would be measured by use of two indicators each.[10]

The FSA highlights that, at the moment, firms are accepted to LIBOR panels based on their own merits, while the current LIBOR administrator would not ensure that the panel is representative overall. We agree that, as part of its role, the Benchmark Administrator ("***BMA***") should design and implement the necessary procedures to establish panels of Submitters that are representative for the respective market. Our experience in operating a range of submission-based services has shown that the ideal membership of panels of Submitters is not static but will typically evolve over time. For our contribution-based services we will therefore continuously monitor observable market activity to ensure that our contributors are indeed active in the market place.[11] For this purpose, we will also review the data quality of the submissions that we receive[12] and monitor market activity of the various participants, for example the number of runs and quotes that firms provide to the market or their primary market activity for OTC traded cash instruments.

We therefore believe that, regardless of how valid the specified categories and indicators are today, the BMA should monitor additional factors and review categories and indicators regularly as well as ad hoc to verify that they are still fit for purpose. Where necessary, the BMA should revise factors and/or indicators accordingly.

DP2: What are you views on how many institutions should form the 'super-set' that contributes to LIBOR?

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[7] Section 4.2, FSA Discussion Paper.
[8] For the avoidance of doubt, our comments refer to the general approach that the FSA is taking to determining the composition of the LIBOR panels. Markit does not have any view on whether specific firms should or should not contribute to LIBOR.
[9] Sections 4.10 and 4.13, FSA Discussion Paper.
[10] The chosen indicators for the three categories are: total assets and G-SIFI status (Footprint), total debt and syndicated loan book (Lending/Borrowing), as well as outstanding volume in Interest Rate Derivatives and prime/selected dealer status in major government bond markets (Expertise).
[11] On a global or on a regional scale respectively.
[12] We have found, for example, that firms that cease being active market makers are more likely to submit either stale data or only recycle a previous day's composite price.

The Wheatley Review stated that "large panel sizes would benefit the accuracy and reliability of the benchmark" [13] by discouraging attempts to manipulate the benchmark while increasing its overall representativeness. The FSA proposed that the top 30-40 institutions that are captured by the methodology should contribute to LIBOR to ensure that they have the relevant expertise. It further noted that these could be viewed as a "super-set of firms" which meet the criteria.[14]

While larger panels can reduce the ability to manipulate a rate, we believe that the impact of increasing the number of contributors on the representativeness of the panel is less certain.[15] This is because only "active" market participants that have a sufficient level of appropriate expertise can provide an informed reflection of borrowing costs in the market. While we agree that it should be an important objective for the FSA to ensure the continuity of LIBOR we therefore believe that it should carefully consider, for each of the respective panels, whether a broadening of participation in the panels would actually deliver the expected benefits.[16]

For the contribution-based pricing services and indices that we operate we generally work to ensure that the panels of contributors include the vast majority of the active market makers[17] in the underlying products. Our experience has shown that increasing the size of a contributor panel per se does not automatically improve the quality of the pricing, and that it will sometimes have the opposite effect.[18] We therefore believe that, in this context, the FSA should take the following considerations into account:

- The optimal panel size for a contribution-based benchmark will depend on the number of parties that are sufficiently active in the underlying market and have the appropriate expertise and experience;
- Equally, the decision whether one or several contributors should be added to a given panel should depend on whether any firms that are not panel members are likely to contribute independent, accurate and knowledgeable information;
- The optimal size of the panel will not be static. The BMA should therefore review panel membership on a regular basis in order to reflect changes in the relevance and activity of the contributors; and
- The "super-set" of panel members should consist of active price makers and liquidity providers in the market based on their actual activity in the relevant market,[19] which could then be broken down into specific product subsets.

DP3: Do you agree with our approach to determining currency expertise?

The FSA noted that contributions to specific currency panels would depend on the relevant currency expertise. It proposed that this expertise could be identified on the basis of the firm possessing a banking or securities lending license, or an authorisation in a currency area and/or having a market making role in the relevant government bond markets.[20] The FSA further noted that its target for the number of Submitters

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[13] Paragraph 5.23, Wheatley Review of LIBOR: Final Report. September 2012.
[14] Section 4.17, FSA Discussion Paper.
[15] In line with the responses to the Wheatley Review.
[16] "However, we reserve the right to consider requiring firms to submit to LIBOR if we begin to have concerns that the continuity of LIBOR, or a particular currency panel, is at risk or the size of a particular currency panel is not sufficiently representative." Section 4.24, FSA DP.
[17] We consider active market makers to be institutions that are making two-way markets on a significant portion of the traded instruments in a market segment. Changes occur when market makers merge, go out of business, or close/spin-off certain businesses. In addition, we will work with local market makers, i.e. regional participants in specific countries/regions such as Europe, Japan, or Asia.
[18] Simply adding further contributors to a panel will often result in reducing the quality of the resulting index, not improving it. For example, for a product with only 5 active market makers, the goal of the index sponsor should be to encourage those 5 firms to contribute to the service. Adding a further 5 contributors that are not market makers and do not follow the market on an ongoing basis will only add "noise" to the composite price and reduce its quality and informational content.
[19] The activity level can be measured in different ways depending on the market or instrument including number of trades, number of positions, number of active price points and the capital involved.
[20] Section 4.18, FSA DP.

to the relevant LIBOR panels would be a minimum of 20 firms in the future, which would represent a significant increase from the between 11 and 18 firms that are submitting now.

We agree with the FSA that it should be the parties with the relevant currency expertise that should contribute to specific currency panels. We believe this could be achieved by breaking down the FSA-specified "super-set'" into appropriate panels for specific markets and/or currencies. Based on our experience we believe that the addition of market participants that are local and/or active regionally to panels for certain currencies in addition to the large global firms might also be useful. We believe that it will be important for the BMA to review each list of "currency experts" periodically in consultation with the Oversight Committee ("***OC***") to identify and reflect any exits and entrants to the market.[21]

DP4: What do you think is the best process for expanding the LIBOR panels and encouraging firms to participate?

We believe it is important that the relevant Submitters are represented on the various LIBOR panels and we agree that it would be beneficial if firms considered voluntarily applying to submit. We therefore encourage the FSA to pursue this objective as a priority by maintaining a the dialogue with the relevant firms and take their views into account.

The FSA notes that any enlarged panel must be credible, and chosen according to properly assessed, objective criteria.[22] We believe that the rules that govern participation in panels of contributors to benchmarks should be transparent and result in panels that appropriately reflect the nature of the benchmark and ensure accurate representation of the relevant market segment. For the various indices that we sponsor, we generally work to ensure that contributor panels include the vast majority of the active market makers in the underlying products.

We welcome the fact that the FSA considers situations where some firms that have not been identified as contributors based on applying the agreed upon factors, might feel that they have particular expertise in a currency, and that the FSA recommends for such firms to further discuss this issue with the LIBOR BMA. We regard this as a sensible approach given the likelihood that applying the pre-determined indicators might occasionally fail to identify all relevant firms. We believe that this situation should not necessarily be regarded as a failure of the factor-based approach, as it could often simply be caused by rapid changes in market conditions or structural changes in the industry. We therefore believe that it would be useful for the FSA, in cooperation with the BMA, to establish a process that allows any firm to approach the BMA, provide evidence of its expertise and/or activity, and request for the BMA in consultation with the OC to determine within a certain period of time whether to accept or reject the firm as a Submitter to the relevant LIBOR panels.

DP5: Do you agree with our proposed approach for determining the circumstances in which the FCA would take up its powers to require submission to LIBOR?

We generally believe that all stakeholders, including both current and potential Submitters, have an interest in restoring the credibility of benchmarks, including LIBOR, as quickly as possible in order to avoid further damage to the functioning of financial markets. We therefore support the FSA's approach to further explore opportunities to work with the industry on designing an appropriate approach to defining panel membership before considering making use of its compulsion powers. We believe that, as long as the FSA allocates sufficient time and resources to this discussion with the industry and individual firms, it might not need to use such powers.

In this context, the FSA should take into account that benchmark sponsors that rely on regular, voluntary contributions from firms for the construction and/or calculation of a benchmark will need to create sufficient

[21] The FSA should note that during the recent financial crisis within a short period of time several large market makers exited the market while several others regarded this as an opportunity and started market-making activities in certain instruments.
[22] Section 4.7, FSA DP.

incentives for their contributors to submit data on an ongoing basis and to ensure the accuracy of their contributions. In our experience, several mechanisms can be used to help advance this balance, but not one set of incentives will work in all cases. In contrast, regulation that imposes overly burdensome requirements and/or liabilities on Submitters will increase the risk of them deciding to discontinue their contributions. This would have the negative side effect of immediately reducing the quality of existing benchmarks, including LIBOR, and potentially also their number. It would hence harm transparency in the marketplace and discourage efforts to improve data availability for illiquid market segments, to the detriment of all market participants and the public.

The FSA should therefore ensure that the regulatory regime that it establishes for benchmarks, including LIBOR, is not unnecessarily burdensome and/or costly for Submitters to result in discouraging them to participate in contributing to these products. Specifically, any regime should be carefully calibrated and proportionate which will ultimately help avoiding the need to make submissions mandatory.

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Markit appreciates the opportunity to comment on the FSA's Discussion Paper on *The regulation and supervision of benchmarks.* 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

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