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Committee of European Securities Regulators
Submitted via www.cesr.eu

European Central Bank
Submitted to ecb.secretariat@ecb.europa.eu

ESCB/CESR Draft Recommendations for Central Counterparties as amended for OTC Derivatives

London, April 16th, 2009

Dear Sirs,

Markit welcomes the publication of the *ESCB/CESR Draft Recommendations for Central Counterparties as amended for OTC Derivatives* and we appreciate the opportunity to provide you with our comments.

Markit is a financial information services company with over 1,200 employees in Europe, North America and Asia Pacific. More than 1,500 institutions use our independent services to value financial instruments, manage risk, improve operational efficiency and meet regulatory requirements. Markit owns and operates Markit Wire, the leading trade processing platform for OTC derivatives, which has been feeding trades into central counterparties (CCPs) for many years. We are also a leading provider of independent CDS pricing data, operate the Reference Entity Database (RED) for CDS, and administer the tradable credit indices Markit iTraxx and Markit CDX. Given the range of OTC derivatives related services that we provide we have actively contributed to the creation of CCPs for CDS in Europe, North America and in Asia. We are also working closely with all potential providers of clearing services to enable their access to reliable data, licences, and other relevant services. We therefore feel well positioned to comment on your recommendations for central counterparties.

European Data Warehouse for CDS

Whilst we understand some of the underlying reasons that caused European regulators to call for the creation of a European Data Warehouse for credit derivatives, we would like to draw your attention to a number of issues to consider as part of your feasibility study.

We do agree that the transparency of OTC transactions and the legal basis on which contracts are agreed has important implications for the proper supervision of the OTC derivatives markets. The legal basis of contracts is defined by the trading venue and the legal confirmation mechanism that is used for determining which law will govern the contract. The Trade Information Warehouse for CDS offers a central venue to store the results of these procedures so that market participants and supervisors alike can assess the current status of a contract and use it as basis for further post-trade processing actions.

That said, we do agree that the creation of a European Trade Information Warehouse for CDS might improve the certainty of access for European regulators to CDS-related information. However it has to be recognised that such a warehouse would only provide access to transactions related to European Reference Entities, not to the entirety of OTC exposures or activities of European financial institutions. Recent losses on synthetic US subprime exposure held by European institutions for example would not have been captured in a European Trade Information Warehouse.

As access to the global positions of European banks by European regulators cannot be provided through a European Trade Information Warehouse, it must instead be secured through appropriate cross border agreements or legal structures. It is worth considering that the separation of European CDS activity into a regional warehouse would create regional fragmentation and might actually make it more difficult to achieve the required supervisory access to other data warehouses. European regulators should also carefully consider the significant additional costs and operational risks that the creation of a separate European Trade Information Warehouse would cause.

Further Aspects

We are a strong supporter of your calls for a wider adoption of faster and automated affirmation and confirmation of all derivatives trades, as well as of portfolio reconciliation and compression and would like to provide you with an update on progress to date as well as on some of our initiatives that have been designed to support these calls:

- Markit through its Markit Wire platform currently enables the electronic confirmation of over half of all interest rate derivative trades globally, with over 95% of these trades being confirmed on trade date. Also for many years Markit Wire has been the major provider of interest rate derivative trades into the LCH SwapClear platform which is the leading CCP for the interbank interest rate OTC market.
- Subject to final regulatory approval, Markit will combine its OTC processing platforms with those of DTCC to create a single global OTC derivatives confirmation platform, separate from the Credit Warehouse, to handle electronic confirmations for the credit, rates and equity OTC markets. The combined business, to be called MarkitSERV, will be owned equally by Markit and DTCC and will be headquartered in London. The creation of such an integrated trade

processing platform will provide additional incentives for users to adopt electronic confirmation of trades, and will allow the industry to extend the applicability of electronic confirmations to additional asset classes and products.

- Markit performs the market standard portfolio compression service for single-name credit default swaps together with Creditex. The service takes in trades from over 15 broker-dealers, assesses their net position, and nets them down towards that position to the maximum extent possible using replacement single-name CDS. Launched in August 2008 in response to regulators' demands, the service has reduced the economically redundant positions in the portfolios submitted by over 80%, equivalent to over \$2.9 trillion notional and more than 400,000 trades. It is worth noting that even where CCPs exist, there is still a need for a compression service, e.g. in CDS for credits that are too illiquid to be cleared. The interest rate derivatives market for example has used CCPs for many years, while there is still significant demand for compression services.

Markit views it as critical that all systems must be in place to allow regulators to oversee the derivatives markets. We are of the opinion that as many trades as possible need to be confirmed electronically and a complete record of all of those trades needs to be created and made accessible in central locations. While for some market participants the wider adoption of electronic trading seems the logical answer to addressing remaining trade processing and settlement issues, it is far from clear what exact benefits it would actually provide for OTC derivatives. In our view, given the bespoke nature of most OTC products, it is quite unlikely that they can be traded successfully on an electronic exchange which implies that these trades need to be captured elsewhere. We believe that, as long as efficient electronic affirmation or confirmation mechanisms are in place, the market itself will be in the best position to choose the most efficient trading venue which might be on-exchange for some instruments, and over-the-counter for others.

Legal Risk

Your statement that a CCP may accept trades from a range of sources including exchanges, electronic trading platforms, and over-the counter markets might in our opinion require some further clarification.

Whilst it is correct to say that the trades cleared by a CCP might have been executed through different means, the description "accept from different sources" seems to refer to the source which actually provides the trade details to the CCP. In reality, the most logical source of trade information for OTC derivatives would be a trade processing platform such as Markit Wire, the DTCC Trade Information Warehouse (for CDS), and in the future MarkitSERV, rather than an electronic trading platform or an exchange. We would therefore recommend removing "over-the counter markets" and adding "TIWs" and "trade processing platforms" to this recommendation.

Margin Requirements and Investment Risks

We do support your recommendation that CCPs should only accept assets as collateral that have "minimal credit, market, and liquidity risks" and that they should take historic price volatility, jump to default risk and market liquidity into account for their margin calculation, all of which can change throughout the life of the transaction.

Whilst we agree with these recommendations, we are of the view that the real challenge lies in determining how these risk properties will actually be measured in practice. It is quite surprising that even recent regulatory consultations still rely on rather static measures such as credit ratings or ad hoc liquidity polls, to quantify the relevant risk properties. However these approaches do not reflect the dynamic nature of the risk that a CCP is exposed to nor do they seem sufficiently objective or scalable.

CCPs for OTC derivatives have to perform the challenging task of implementing risk measurement with a systemic importance for thousands of products and maturities on an ongoing, often even on an intraday basis. The goal must therefore be to identify measures of credit, volatility, and the liquidity risk of the positions in OTC derivatives and the products accepted as collateral. These risk measures should not only be an accurate reflection of the current level of the risk parameters but they should also be forward-looking, updated dynamically, available for the majority of relevant products and maturities, objective, observable, easy to source and simple to compute. Only this combination of attributes will maximise the transparency that a CCP can provide to the market about its risk management methodology and minimise the cost and potential for uncertainty.

Fortunately the financial markets do provide independent indications of all three required product characteristics and these market-based measures are indeed easily observable and transparent, updated frequently, and built on both the expectations and actual transactions of all relevant market participants. Given that CCPs mostly use market-based indicators to measure credit risk and volatility already, the more critical question is how they could measure the liquidity of their OTC derivative and collateral positions.

Liquidity Measurement

The risk property “liquidity” of a financial product reflects the ability of the CCP to sell a position in the market close to the current price within a certain time period. The challenge consists in quantifying and measuring this potential future liquidity for financial products in an objective and accurate way. Ideally, this measure should be observable, updated dynamically, forward looking, and it should be available for the majority of relevant products.

Unfortunately, liquidity is not only an important risk property of a financial product, but is also notoriously hard to measure. Whilst some market participants would propose using past trading activity to assess future liquidity, the use of transactional volumes is exposed to a number of theoretical as well as practical issues. Overall they seem rather ill suited for the desired purpose and will only ever provide information for a small fraction of the universe of relevant products anyway.

Fortunately, more reliable and appropriate measures of the expected future liquidity of financial products are available:

- Markit currently creates liquidity scores for more than 1,000 CDS names on the basis of CDS Quotes, i.e. the bid/offer runs that we receive from the market makers. The Quotes based liquidity report uses the number of unique quotes, the number of market makers providing quotes, as well as the quoted bid/offer spreads as the basis for the computation of a “liquidity score”.

- Furthermore we have been computing and publishing Data Quality Ratings for a range of products for many years. Data Quality Ratings represent a good proxy for the liquidity of a product given that they are derived from the number of accepted pricing contributors for the product, the freshness of the data, and the range of accepted contributions, i.e. the difference between the highest and the lowest accepted prices. All else being equal, a higher number of accepted contributors, a greater freshness of the data, and a narrower range of accepted contributions will lead to a higher Data Quality Rating. If all of these factors are in place, they signal that the investor will likely be able to liquidate a position quickly, and close to the current price when needed. Based on the current data set, we publish Data Quality Ratings for more than 2,100 Credit Default Swaps (5 year maturity point) and more than 5,300 bonds globally which are updated every day.

Both Quotes-based Liquidity Scores and Data Quality Ratings are dynamic as they will reflect changes in the underlying variables on a daily basis. Using market-based liquidity measures in addition to using credit spreads for credit risk and volatility calculations will provide CCPs with an accurate, dynamic, scalable and transparent measure of one of the major risk characteristics of the products they clear or which they accept as collateral.

Operational risk

We support your recommendation that CCPs should identify and analyse sources of risk from external factors such as trading and settlement arrangements and their vulnerability arising from their reliance on a small number of outside service providers.

That said we are of the view that all external providers to CCPs need to recognise the systemic risk implications of a potential failure in their service and therefore need to put appropriate resiliency and disaster recovery facilities and procedures in place. Markit in its function as a service provider to the CCPs has established detailed Service Level Agreements (SLAs) with respect to the provision of pricing data which requires stringent Business Continuity Plans (BCP).

It might be appropriate to clarify in your recommendations that the existence of multiple providers will only help mitigating operational risk if their services are seamlessly interchangeable. For example, if all European CDS trades were stored in a European warehouse, the failure of that warehouse would impact European CCPs regardless of the existence of a US Warehouse.

Transparency

We do support your recommendation that CCPs should provide an appropriate level of transparency about the price sources and models that they use to calculate their margins and to determine the exposure to their participants.

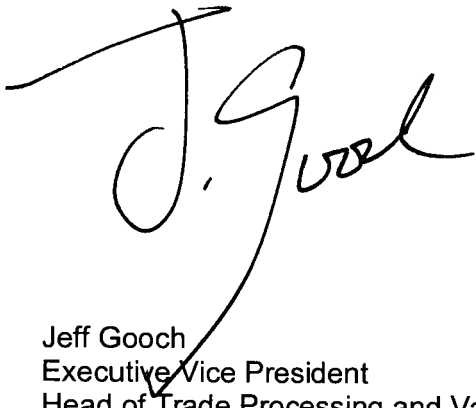
That said we want to point out that Markit has been working with both major market participants and CCPs for CDS for an extended period of time to devise the most appropriate algorithms to clean data and to create reliable clearing prices. More specifically, Markit's input was instrumental in defining and implementing a new price submission process in cooperation with the leading market makers to support the central clearing of

CDS. The process is based on the clear identification of instruments and the obligation for market makers to provide prices for a defined size with a maximum bid-ask spread within a five minute submission window. Also, in order to ensure quality of price submissions, periodic trading activity for off-market submissions is envisaged. The methodology that underlies the price fixing process is transparent and the names of data providers are made available.

Whilst the price that is determined through this process is currently used by one of the CCPs for CDS margin calculations, Markit is in discussions on how it could be made available to all other CCPs for CDS. We will also, in conjunction with the clearing houses, make all of the pricing data that is generated available, without restriction, on commercially reasonable terms. Finally we will make some of the data freely available in order to bring greater transparency into the derivatives markets. Please refer to our CDS transparency webpage www.markit.com/cds for more details.

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,



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