

Basel Committee on Banking Supervision
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Secretariat for the Accounting Task Force
Centralbahnplatz 2
CH 4002 Basel
Switzerland

External audit quality and banking supervision

London, January 14th, 2009

Dear Sirs,

Markit welcomes the recent publication of *External audit quality and banking supervision* by the Audit Subgroup of the Basel Committee. While we broadly agree with your observations, we thought it might be helpful to provide you with our comments on some of the topics that were covered in this paper.

Markit is a 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 market with fair value levels in over-the-counter derivatives.

Totem Valuations collates market makers' best estimate of the mid-market price for all of the derivative instruments that they trade across all asset classes. Using these contributions, we create a single composite price for each instrument and maturity that is covered by the service. All prices are rigorously tested to ensure that they are appropriate given other pricing levels and market inputs. We have conducted continuous analysis and testing over the years and are of the view that the resulting prices are more representative of "fair value" than those from any other source, including inter-dealer broker prices, model based prices, or some closing prices of exchange-traded products.

Today, all major banks, broker dealers, buy-side clients, and commodities traders use Markit's services to assist them in the process of determining the fair value of their positions. Also, a large number of banks will incorporate Markit's independent price information in the preparation of their financial accounts.

On that basis we have established an on-going dialogue with all of the major audit firms, the standard setters as well as the accounting and audit groups of the regulators. We have also actively contributed to the discussions on how to determine fair value for products that do not actively trade. That said we would be very interested in establishing a dialogue with your group in order to support you in your discussions about valuation challenges for auditors and banking regulators. Please find below some of our thoughts which we hope you will find useful.

Markit and the Audit Community

Given the importance of Markit's data for the preparation of financial accounts we have been working very closely with all major audit firms for many years. We try to provide them with an in-depth understanding of the coverage, the sources, the cleansing algorithms, and the resulting quality of our data. We also update them regularly on the current challenges that we face, as well as our initiatives and new products.

In addition, we have also established direct client relationships with many audit firms. To support them in their tasks of verification, revaluation and analysis we have created a highly customisable solution for the global audit community that leverages our comprehensive suite of data and portfolio valuation products to support these functions.

One significant problem faced by audit firms is that they often struggle to license data quickly when new asset classes suddenly show up in their clients' portfolios. As such, Markit has designed a product offering that provides auditors with access to the full range of Markit's pricing services under a "pay as you go" commercial framework. Such a product will alleviate the need for auditors to receive a license for new content before they can start developing their expertise and applying their knowledge to a given audit. With access to the full range of data and valuations from the beginning, auditors are empowered to stay ahead of the learning curve, as it removes the current administrative barriers that hamper the ability to access mission critical content in a timely fashion.

Increased Reliance on Auditors' Expertise

Whilst we do agree with your observation that the increased complexity of financial instruments might create more uncertainty around valuation, we thought it might be worthwhile to provide you with some background information on Markit's pricing and valuation services that might help address some of your concerns.

Markit's pricing services cover the full range of credit products, such as CDS, ABS, loans, and bonds, and also exotic OTC derivatives across all asset classes, i.e. structured credit, interest rates, equities, commodities, and FX. Most of our pricing data can be described as consensus prices and our pricing services generally work as follows: firstly we receive end-of-day book-of-record prices, or best estimates of mid market for Totem, from our contributors, which are in essence all the relevant market makers for this product. We then apply a number of cleaning algorithms to the data, testing amongst others for arbitrage-freeness, flat curves, stale data, and outliers, on the basis of which we reject up to 60% of the data for some asset classes. The accepted data will be used to compute a consensus price, which is just the simple average of the accepted contributions.

It is worth pointing out that most of our pricing services do actually cover products that are illiquid or do not trade. Using European ABS as an example, while the asset class probably consists of 5,500 relevant bonds and only an estimated 50-100 of those trade every week, the Markit European ABS pricing service currently provides daily consensus prices for more than 4,300 bonds. Also, it is worth emphasising that despite the much reduced trading activity and increased uncertainty in the markets the coverage of our consensus pricing services has not really changed over the last two years, with the exception of rare events where market makers completely disappeared. While the ranges of contributions that we receive might have widened, market makers still have to determine a mark-to-market price for all their positions at the end of the day. This end-of-day book-of-record price will then be submitted to Markit as a contribution, no matter how much volatility or illiquidity can be observed for this product.

Data Quality and Potential Imprecision

As to the potential imprecision of fair value estimates, particularly related to illiquid products, you should be aware of the fact that we not only try to be as transparent as possible about the inherent uncertainty of our pricing data, but we also have a number of procedures in place to maximise its quality:

- As part of our pricing services, we will provide clients with a wealth of information to allow them to form their own view on the inherent uncertainty of our pricing data. In addition to consensus prices, we will provide information such as the number of contributors, the range of accepted contributions, and the actual names of contributors to the service. Additionally, for products covered in Totem, we will publish the standard deviation and also often the skewness of the distribution of accepted contributions.
- We also provide regular data quality reports to all market makers which they will use to analyse the quality of their marks and follow up with the relevant traders to address potential shortcomings. Participation in the Totem service in particular will often lead to discussions between front and back office as the Totem data allows the back office to challenge traders' marks actively based on evidence obtained from traders' peer groups.
- To further improve the quality of our data, we are increasingly using additional data sources in order to validate our end-of-day consensus prices:
 - Quotes data, i.e. bid/offer runs that we receive from the market makers, will allow us to assign a higher importance to end-of-day contributions from those dealers that are active in the name and provide quotes that are consistent with their end-of-day levels.
 - Also, for some asset classes such as leveraged loans, we have started using transactional data to validate our end-of-day consensus prices.

Lack of Consensus about Model and Inputs

We do agree with your observation that for some complex products a consensus on some of the inputs and on which model should be used to price them seems to be lacking. That said, we would like to point out that the Totem service, which provides consensus pricing for exotic derivatives across all asset classes including equity and credit correlation products as well as highly complex products such as Power Reverse Dual Callables (PRDCs), will help address both of these concerns:

- While the Totem service does not intend to create a consensus about which model to use to price a complex derivative product, it will enable contributors to calibrate their models to the full range of consensus prices that they receive across all maturities and strikes, and thus derive consensus “correlation” or “volatility” assumptions for each product.
- If there is no observable consensus price for some of the inputs that are needed to price a more complicated derivative product, Totem has a track record for introducing a price verification service to create a consensus specifically for these inputs. Sometimes we will even oblige market makers to participate in such a service, hereby reducing the number of unobservable inputs without a market consensus:
 - When the price verification service for PRDCs was introduced, we decided to also add FX skew and correlation (via quanto swaps) out to a 30 year maturity to our services, as they were initially unobservable inputs to the pricing of these products. By launching a consensus service for these inputs we significantly increased observability in the market, both for the market making banks and their auditors.
 - One issue which has become quite relevant recently is the calculation of a consensus yield curve. Given the basis that has developed between swaps, Libor, and government bonds, more care needs to be taken over what rates are used to construct a yield curve and how that curve is used. Totem has hence decided to not only poll the market makers for curves based off three-month and six-month Libor but also to offer a “basis service” where market makers contribute their best estimates of mid-market for basis adjustments on a spot as well as on a forward starting basis.

Data Histories

Regarding the lack of data histories, we would like to point out that our clients have access to the full data history going back to the time when a product was added to the pricing service. For plain vanilla interest rate derivatives such as swaptions, this will be 1997, while the synthetic CDO pricing service started in April of 2004.

Increasing Market Confidence

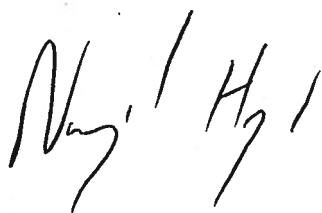
We agree with your observation that valuation challenges that are likely to come up in the audit of illiquid and complex products where sufficient or reliable market data is no longer available, will put extensive demands on auditors to check the robustness of the process used for determining fair value.

In that context one should keep in mind that there is often a wealth of observable data available even for products that do not trade, as described above using the example of European ABS. Strictly speaking, the majority of prices that Markit publishes are actually consensus prices for products that do not actively trade. Our clients will often use consensus prices, such as Totem data, as a starting point when valuing illiquid products. In addition, as part of a consistent valuation policy, they will validate our data using other data sources such as transaction or broker prices.

It is worth stating that given the recent developments in the area of accounting standards, be it the reclassification option under IFRS or additional guidance for FAS157, which both constituted a move away from the well established concept of fair value, even the highest quality audit will not necessarily be able to reveal the truth to the market. In our view, the use of internal assumptions, as encouraged by the FSP on FAS 157-3 in particular, has significantly boosted the amount of Level 3 assets that are held by banks. We are concerned that even a diligent auditor might now allow the use of "internal assumptions", which are not necessarily reflective of the "true" fair value as represented by observable data. We would therefore urge banking supervisors and audit firms alike to put a particular emphasis on verifying that users do not simply disregard reliable observable data points when they decide to use their internal assumptions instead. Only the consistent application of fair value, based on observable data such as transactions or consensus prices wherever they are available and can be regarded as reliable, can truly increase transparency and restore market confidence.

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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