

COMMENT LETTER

September 7, 2012

ICI and ICI Global Comment Letter on Wheatley Review of LIBOR (pdf)

September 7, 2012 The Wheatley Review HM Treasury 1 Horse Guards Road London SW1A 2HQ U.K. Re: The Wheatley Review of LIBOR Dear Sir or Madam: The Investment Company Institute¹ ("ICI") and ICI Global² appreciate the opportunity to comment on the initial discussion paper on the London Inter-Bank Offered Rate ("LIBOR") by the Wheatley Review.³ On behalf of their investors, ICI and ICI Global members collectively manage over \$5 trillion in fixed income and money market instruments. These members also regularly trade in financial contracts such as futures, forwards, options and swaps. Many of these instruments contain terms that reference LIBOR. ICI and ICI Global members and their investors therefore have a compelling shared interest in ensuring that LIBOR is a robust and accurate benchmark. We agree with the Discussion Paper's premise that the credibility of LIBOR has been eroded by alleged recent misconduct on the part of LIBOR contributors.⁴ We therefore strongly support the Review team's consideration of ways to strengthen LIBOR or develop alternative benchmarks. As is evident from the Discussion Paper, however, whether this is possible and how it might be done are far more difficult questions.

1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.3 trillion and serve over 90 million shareholders. 2 ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US \$1 trillion. 3 The Wheatley Review of LIBOR: initial discussion paper, August 2012, available at http://hm-treasury.gov.uk/d/condoc_wheatley_review.pdf ("Discussion Paper"). 4 Discussion Paper at 3. The Wheatley Review September 7, 2012 Page 2 of 6 While we appreciate the sense of urgency about formulating appropriate policy recommendations, we are concerned that the timetable the Review team has set may be unrealistic. It is critically important that the Review team have enough time to gather and digest a range of information and perspectives, enabling it to advance policy recommendations based on full and careful consideration of all material issues. In consultations with our respective members, we have not found it possible to do a thorough analysis of all of the issues raised in the Discussion Paper in the allotted time. Nonetheless, we are pleased to set forth our preliminary views below, with the hope that we will have further opportunity to comment as the examination of these issues proceeds. At the outset, we should note that strengthening the credibility of LIBOR, and restoring investor confidence in it, seems preferable to

replacing LIBOR with a new benchmark. As the Discussion Paper acknowledges, LIBOR has become fundamental to the financial system, serving as a reference value for transactions with a notional outstanding value of at least \$300 trillion. It is far from clear, certainly at this stage of the review process, whether any alternative to LIBOR would be feasible. In any event, an alternative benchmark would have its own limitations, and migration to an alternative would entail its own risks as well as considerable practical hurdles and costs. While challenging in its own right, strengthening and reviving the credibility of LIBOR would avoid a number of operational challenges associated with replacing the benchmark. To that end, we recommend making the rate-setting process more fact-based and transparent. This might be done, for example, by using transaction-based data in LIBOR calculations wherever possible. We also support methods to improve governance of the rate-setting process. Our views are discussed in more detail below.

Background: The Importance of LIBOR to Investment Companies As managers of money market mutual funds and short-term bond funds, ICI and ICI Global members invest billions of dollars on behalf of shareholders and clients in short-term instruments indexed to LIBOR. These instruments include commercial paper, certificates of deposit, syndicated bank loans, corporate bonds, and mortgage-backed securities. Many members also trade derivative contracts on behalf of shareholders and clients that have terms that reference LIBOR, such as futures, forwards, options and swaps. Despite recent deficiencies, LIBOR remains the primary measure of interbank funding costs and hence is a good measure of bank credit risk. Having an accurate assessment of bank credit risk is critical to the pricing of many financial instruments. Because of its important role and because it is so deeply embedded in the financial system, we generally support efforts to maintain and improve LIBOR.

Recommendations for Preserving and Strengthening LIBOR Although we concur with the Discussion Paper's conclusion that the credibility of LIBOR has suffered recently, it is important to recognize that, even in its compromised state, LIBOR retains a number of strengths. For example, LIBOR generally has fluctuated with market determined rates, so it still reflects the term structure of short-term interest rates and interest rate expectations. Also, LIBOR, however imperfect, continues to be the best available measure of interbank funding costs: banks are The Wheatley Review September 7, 2012 Page 3 of 6 often key counterparties involved in short-term dollar instruments tied to LIBOR and must necessarily fund these positions at interest rates that vary with LIBOR. These benefits of LIBOR, as well as the challenges of developing and migrating to a new benchmark (discussed in more detail below), underlie our preference for preserving, strengthening, and thereby restoring investor confidence in LIBOR. To that end, we support exploring the use of transaction data and other verifiable empirical data to corroborate submissions. We also support steps to improve the governance and oversight of the LIBOR process. We recognize, however, that if the administrative costs and burdens placed upon LIBOR contributors becomes too high, these banks may cease to participate. Thus, any consideration of reforms to LIBOR must take proper account of the impact on participants.

Recommendations on the Rate-Setting Process As the Discussion Paper explains, the availability of data on transactions underlying LIBOR varies widely across maturities and currencies.⁵ We support using available transaction data on bank borrowings to corroborate LIBOR submissions in those maturities and currencies where there is sufficient data to do so -- e.g., for shorter term rates based on the US dollar, Euro, and Sterling. We further recommend that the calculation methodology clearly set forth a minimum level of transaction data for each currency and maturity that must be available for this "direct" corroboration. We recognize that there are limitations to the use of transaction data. Nonetheless, we believe the benefits of this approach outweigh the costs. For example, the use of direct transaction data will only be possible for a subset of existing LIBOR rates, meaning that the calculation methodology will vary across rates. It appears, however, that the rates for which sufficient transaction data

are available are among most heavily used, so the approach will have a widespread, if not comprehensive, benefit.⁶ The use of actual transactions also may increase the measured volatility in rates, to the extent that it replaces bank estimation techniques, but we believe this potential cost to end users of LIBOR is an appropriate tradeoff for a more robust benchmark. Finally, participating banks may have legitimate concerns over providing proprietary transaction data. Those concerns could be mitigated by making the data available only to regulators or to some trusted agent subject to appropriate safeguards. As to maturities and currencies for which specific transaction data are less available, we believe further study is necessary to determine whether these LIBOR rates should be maintained. If they are to be maintained, other data sources should be explored to aid in their calculation. For example, data for other durations could be used for corroboration by interpolating the yield curve. To the extent such data are used, the calculation methodology should clearly explain how the rates are calculated. ⁵ Discussion Paper at 24.

⁶ At a minimum, the majority of ICI and ICI Global member transactions that reference LIBOR are based on the rates where significant transaction data is available. The Wheatley Review September 7, 2012 Page 4 of 6 Alternatively, narrowing the coverage of LIBOR with respect to those currencies and maturities for which transaction data are extremely limited may be appropriate, and would have the added benefit of reducing the administrative burden on reporting banks. Recommendations on Governance and Oversight We support exploration of several ideas in the Discussion Paper with respect to improving the governance and oversight of the LIBOR-setting process. As noted above, we are cognizant that overburdening contributing banks may ultimately reduce their incentive to participate, but we believe several suggestions in the Discussion Paper are beneficial without being overly burdensome, and may in fact redound to the benefit of contributing banks. For example, the proposed code of conduct described in the Discussion Paper⁷ could improve the submission process and results, while also enhancing the reputation of participating banks. As the Discussion Paper recognizes, however, the effectiveness of such a code will in large part depend on the credibility of the oversight provided by the designated governing body. In this regard, expanding membership of the Foreign Exchange and Money Markets Committee, which oversees LIBOR, to include a wider range of interested groups could enhance the scrutiny and oversight of LIBOR. As the Discussion Paper suggests, increasing the presence of representatives such as non-contributing banks, exchanges and clearinghouses, and users of financial products may be beneficial.⁸ We agree with the Discussion Paper that the effectiveness of such a code would also depend upon the ability to sanction contributors for misconduct, which is something the Paper recognizes is difficult for an association without regulatory or self-regulatory responsibilities to undertake. Three options, which could operate in combination or separately, are suggested to address the enforceability of the regime: full regulation under the Financial Services and Markets Act of 2000; standalone application of the civil Market Abuse regime; and criminalization of breaches of the code. We recognize that each approach has benefits and drawbacks. The analysis undertaken so far, however, is insufficient to demonstrate clearly what the most effective solution would be. While we support the objective of a code that has “teeth,” the implications of these types of reforms highlight the need for the Wheatley Review to engage in a thoughtful and deliberative process before making its policy recommendations.

⁷ As set forth in the Discussion Paper, such a code of conduct could cover, for example: internal policies covering the submission process, including compliance, audit, and record-keeping; organizational structures, in terms of where the LIBOR submitting function should be located within the bank; and disciplinary procedures. Discussion Paper at 27. ⁸ Discussion Paper at 26. The Wheatley Review September 7, 2012 Page 5 of 6 Challenges of Developing and Migrating to a New Benchmark ICI and ICI Global members are skeptical about the potential for developing a workable alternative benchmark in place of LIBOR, and

have deep concerns about the practical implications of a migration to a new benchmark.⁹ As noted above, despite its recent loss of credibility, LIBOR remains a key benchmark interest rate. This is not only because it is deeply embedded in myriad existing financial contracts, but also because it continues to reflect banks' funding costs more accurately than any current alternative. The development of an alternative that adequately reflects bank funding costs will presumably implicate many of the same concerns and tradeoffs associated with improving LIBOR, and may face the additional challenge of orchestrating a large-scale migration. Indeed, there are many reasons why investors might not migrate to a new benchmark. For example, many contracts would require renegotiation to reflect the new rate, a process that would be protracted, consume significant resources and present serious operational challenges. Moreover, counterparties are not likely to agree to a new benchmark if their interests are threatened. Further, as the Discussion Paper acknowledges, each of the approaches to migration (i.e., co-existence, pegging LIBOR to the new benchmark, switching on a date certain, and discontinuation of LIBOR) present risks to market participants.¹⁰ Another potential drawback to migration not mentioned in the Discussion Paper would be the fixed operational costs associated with moving to a new benchmark, such as the reprogramming of computer systems. And ultimately, even if viable alternative benchmarks are developed, the economic terms in any contract are a matter of choice for the parties to that contract, so there are no assurances that investors will adopt the replacement benchmark.¹¹ None of these concerns should preclude further consideration of alternatives to LIBOR. It seems clear, however, that the practical hurdles and transitional costs are certain to be significant, while the benefits of an alternative benchmark by contrast are uncertain. * * * * 9 This is not meant to suggest that market participants will not employ alternatives to LIBOR, but rather to address the challenges associated with a regulatory approach to such a migration. 10 Discussion Paper at 40. 11 The Discussion Paper acknowledges this fact: "Ultimately, the choice of benchmarks for financial contracts is market- driven." Discussion Paper at 40. The Wheatley Review September 7, 2012 Page 6 of 6 For all of the reasons discussed above, ICI and ICI Global members believe that strengthening and restoring investor confidence in LIBOR would be preferable to replacing it. We commend the Review team for its preliminary consideration of ways to accomplish this important goal, and we urge it to take the time necessary to gather and digest input, so that its policy recommendations are made only after full and careful consideration of the issues. We sincerely thank you for this opportunity to share our views. If we or our members can be of further assistance as you consider this important matter, please do not hesitate to contact the undersigned. Sincerely, /s/ Paul Schott Stevens /s/ Dan Waters Paul Schott Stevens Dan Waters President and CEO Managing Director Investment Company Institute ICI Global 1-202-326-5815 44-203-009-3101 paul.stevens@ici.org dan.waters@ici.org