LexiFi

30 September 2009

CESR
11-13 avenue de Friedland
75008 Paris

CESR consultation paper on the "Classification and identification of OTC derivative instruments for the purpose of the exchange of transaction reports amongst CESR members"

Dear Sir, Madam,

We are grateful for the opportunity to comment on the above paper and wish to make remarks, on behalf of LexiFi[1], pertaining to the identification of OTC derivative instruments (i.e., Question 2).

CESR suggests that a set of characteristics that describe the main elements of a derivative instrument would fulfil the Market Surveillance requirement of monitoring "positions or exposure in the underlying instruments".

LexiFi wishes to bring three facts to the attention of CESR:

- the fields proposed in III. J. are not sufficient to estimate the positions or exposure in the underlying instruments;
- positions or exposure in the underlying instruments are only one aspect of Market Surveillance: monitoring the value and risks of OTC derivative contracts is crucial to understand the systemic risk that such transactions may create;
- technical solutions exist to create precise and exhaustive descriptions of OTC derivative contracts with a finite set of instructions (about twenty)—the resulting definitions may be exchanged and used to (i) estimate positions or exposures in the underlying instruments and (ii) to measure the value and risks of OTC derivative contracts.

1. Positions or exposure in the underlying instruments

To understand the challenge of estimating positions or exposure in the underlying instruments resulting from OTC derivative contracts, let us consider two examples:

- a contract that pays the maximum performance, measured over a specified period, between two assets;
- a contract that pays one euro if the sum of monthly negative performances of the underlying asset, over a specified period, is greater than -20% and nothing otherwise.

What is the position or exposure in the underlying instrument(s) that results from the above contracts? The notions of position and exposure must be clearly defined and then calculated. The answer is not immediate. And these are relatively simple examples: real-world OTC derivative contracts are potentially much more complicated and there are thousands of variations of them.

At the same time, widely used financial engineering techniques exist to calculate positions and exposures. The minimum requirement to apply such techniques is a precise and exhaustive definition of the terms and conditions of each contract.

[1] LexiFi is a French company that provides software for the analysis, valuation, and management of financial products and portfolios. LexiFi's offering is based on a uniform description of financial contracts. *Attention: section 3 of this document refers to LexiFi's financial contract description technology and expertise.*

2. Value and risks of OTC derivative contracts

Market Surveillance must extend beyond the monitoring of positions and exposures in the underlying instrument to align with the recommendations of the Larosière Report, which calls for the development of "a financial stability early warning system, accompanied by an international risk map[2] and credit register."

The implementation of an international risk map implies access to basic valuation and risk estimation capabilities—approximations are sufficient—which again require detailed knowledge of each contract's terms and conditions.

The challenges of estimating positions/exposures, values, and risks could be addressed if market participants communicated precise and exhaustive product descriptions using the Transaction Reporting Exchange Mechanism (TREM).

3. Formal description of financial contracts

We agree with CESR's statement[3] that "an OTC contract can contain an unlimited number of characteristics" and that a definite set of parameters—e.g., call/put identifier, strike price, expiration date, etc.—cannot be used to identify uniquely each instrument.

Another approach is therefore needed. Rather than creating an endless menu of instruments (e.g., options, swaps, etc.) and an equally endless list of instrument parameters, LexiFi has worked on identifying a limited number of core constructors with which the terms and conditions of financial contracts can be described both precisely and exhaustively. A similar approach was adopted in algebra: four operators enable the accurate definition of an unlimited number of algebraic expressions.

LexiFi has been working over the past ten years to develop and implement an "algebra" for financial contracts. All financial contracts are reduced to a limited set of about twenty core constructors. The resulting contract definitions may be manipulated to estimate positions or exposures in the underlying instrument(s), values, and risks. Contract manipulation functions need to be defined only once: such functions work for all contracts as they operate on the low level constructors.

LexiFi therefore considers the "identification" problem to be technically solved. Market Surveillance requirements could be fully satisfied by requesting market participants to communicate an electronic "algebraic" definition of each contract using TREM.

LexiFi's experts are available to answer your questions and to help.

Yours sincerely,

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[2] See http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf, article 242 and recommendation 27. Abstract of article 242: "A comprehensive early warning system could also usefully be complemented by the creation of an international risk map and an international credit register. The purpose of such a risk map would be to build up a common data base containing relevant information on risk exposures of financial institutions and markets, both at the national and the international level."

[3] Section J, paragraph 1.