LexiFi

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CESR
11-13 avenue de Friedland
75008 Paris

ESCB/CESR consultation paper on draft recommendations for central counterparties revised for CCPs clearing OTC derivatives

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 clearing of non-standard OTC derivatives.

In Recommendation 1 - § C.3, the consultation paper states that "a CCP will generally only ever serve a subset of a given product market." Likewise, the few trade information databases in existence today—a topic evoked in the Introduction - § 3—offer only limited financial instrument coverage, even if such limitations, as discussed below, are less structural than for CCPs.

The goal of reducing the financial stability risks posed by OTC derivatives exposures will be fully achieved only if clearing solutions are developed for non-standard OTC derivatives. Such contracts create potentially significant exposures, in part because non-standard transactions are sometimes difficult to understand and to manage, and exposures may therefore be discovered only relatively late, at a point where they have become sizeable[2].

This letter outlines a possible solution for reducing financial stability risks stemming from non-standard OTC derivatives exposures.

The challenges of non-standard OTC derivatives for CCPs

Non-standard OTC derivatives are difficult to handle using a standard CCP model for at least two reasons:

- From the perspective of the CCP, the potential illiquidity of certain non-standard OTC derivatives may put the CCP's capital at risk due to the magnitude of price changes occurring in the interval between the last margin collection and the effective liquidation of the defaulting participant's positions.
- From the perspective of participants, even if a CCP was willing to bear the illiquidity risk of non-standard OTC derivatives, the higher margin requirements necessary to cover that risk may discourage potential users from participating. The cost of the insurance may be simply too high.

A possible solution: "insurance with a deductible"

The financial stability risks posed by non-standard OTC derivatives exposures could be mitigated by establishing one or more market infrastructure providers that would (i) operate a trade information database and (ii) perform certain functions of a CCP, including the collection of margin, but would not provide a guarantee. Each participant would bear the risk of price movements between the last margin collection and the effective liquidation of the defaulting participants' positions: this Residual Risk is similar to a deductible in an insurance policy.

[1] LexiFi is a French company that provides software for analysing and managing financial products and portfolios. LexiFi's offering is based on a formal language for describing financial contracts.
[2] This phenomenon is currently being evidenced in France where several municipalities and public agencies entered into non-standard interest rate swap transactions to manage their debt.

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Service description

The main features of the possible clearing solution for non-standard OTC derivatives are as follows:

- *Trade information database*. The provider manages a trade information database for non-standard transactions in order to maintain a precise, up-to-date, and shared record of the parties' rights and obligations. The provider records the terms and conditions of each contract, manages contract events, and calculates payments. The maintenance of a precise electronic record for non-standard transactions, not only at inception but also as each contract ages, is a serious technical challenge that most market participants have yet to resolve. The need to reconcile such independently maintained electronic records, for the purpose of clearing, adds to the challenge. The shared electronic record should therefore be created and agreed upon as early as possible—i.e., at inception for new trades.
- *No novation, no guarantee*. A contract between two initial counterparties to an OTC derivative trade is not replaced by two contracts between the provider and each counterparty. The Residual Risk—i.e., the risk of price movements between the last margin collection and the effective liquidation of the defaulting participant's positions—is borne by each participant.
- *Provider establishes margin requirements and collects margin*. Subject to the resolution of legal and technical issues, multilateral netting of variation margin payments can probably be put in place. In the event multilateral netting of variation margin payments cannot be achieved, the provider collects margin based on bilateral netting agreements.
- *Provider publishes eligible valuation methodologies for each instrument type for the purpose of calculating variation margin*. The definition of a valuation methodology covers the following elements: source of market data, financial model, numerical method used to implement the financial model, market data calibration methodology, and financial model implementation parameters. Each pair of participants elects an eligible valuation methodology for each instrument type.
- *Control of Residual Risk*. The provider manages the Residual Risk using standard CCP mechanisms—e.g., participant requirements (capital requirements, minimum credit rating, parental guarantees, access restricted to regulated entities, assessment of operational capacity to meet margin requirements), margin requirements (including intraday margin calls), or the organisation of auctions for the liquidation of the defaulting participants' positions.

Benefits

The proposed solution offers numerous benefits for authorities and market participants.

Benefits for regulators and supervisors include the following:

- Risks stemming from non-standard OTC derivatives exposures are reduced.
- Relevant authorities access non-standard OTC derivatives trade and position information thanks to a central storage of contract details.
- A double control of credit risk remains in force: while the provider establishes participation requirements designed to contain credit risk, participants must still exercise care in the selection of counterparties as they remain exposed to the Residual Risk.

Benefits for market participants include the following:

- Systematic recourse to a central margining utility for both standard and non-standard OTC derivatives reduces credit risk. In addition, the central utility serves as an early warning system for managers and shareholders of market participants.
- Access to central and up-to-date record of the rights and obligations of the parties, on which margin calculations are based, eliminates the need for reconciliation, reduces the potential for disputes, and reduces internal system and management costs.
- The existence of a "deductible", in the form of the Residual Risk, reduces margin requirements and hence the cost of the service.

- The public disclosure of reasonable valuation methodologies brings transparency to many market participants who have not invested in the development of independent valuation capabilities. Proper accounting of positions in non-standard OTC derivatives is facilitated.
- Buy-side participants have a choice of valuation methodology for the calculation of variation margin. The methodology is no longer imposed by investment banks as part of bilateral collateral agreements.
- The potential for multilateral netting of variation margin payments is a source of operational efficiencies when compared with bilateral collateral agreements.

Requirements

The implementation of the proposed solution requires:

- access to a formalism for describing and managing all types of financial contracts in a trade information warehouse;
- access to market data and to robust implementations of valuation models for a wide variety of financial contracts;
- a study on the legal and technical issues linked to the multilateral netting of variation margin payments in a clearing system without novation.

Yours sincerely,

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