

CDS Clearing Platforms Make Some Strides

By Joanne Morrison

For months there has been extensive preparation, but yet no derivatives clearinghouse has begun clearing credit default swaps. And while there is widespread agreement that clearing is a way forward for this \$27 trillion market, numerous obstacles continue to delay a robust launch. Lawmakers and regulators are vying for turf in both the U.S. and Europe; the instruments to be cleared must be restructured and standardized; and some of the more complex instruments may never be suitable for clearing.

Even so, the migration to clearing is making progress. NYSE Liffe, the London-based futures exchange owned by NYSE Euronext, was the first to hit the marketplace. In December it began offering CDS index clearing through its Bclear service in conjunction with LCH.Clearnet. As of early February, however, the platform had not handled any contracts because of delays in firms connecting to the platform.

Three others are in varying stages of readiness. CME Group is close to completing the regulatory approval process for its CMDX platform, a joint venture with hedge fund Citadel. ICE Trust, a new clearinghouse created through IntercontinentalExchange's acquisition of The Clearing Corp., is also waiting for regulatory approval, while Eurex says it is on track to begin clearing index-based contracts by the end of this quarter. (See "Financial Woes Change Landscape for Credit Derivatives" in *Outlook 09*.)

Central clearing is indeed something the major CDS dealers want to achieve and they have committed to doing so both in the U.S. and Europe. Most recently, a group of nine firms in a Feb. 17 letter to European Commissioner Charlie McCreevy vowed to clear certain European-based contracts on a system regulated there. The details of determining which contracts would have to be cleared this way are not finalized. The nine firms said they would "work to resolve" outstanding technical, regulatory, legal and practical issues by March 31 and committed to a July 31 deadline for clearing those contracts that are deemed eligible for clearing.

But before clearing can take off, major changes must be made in the underlying market. Industry experts say clearing will not gain any real traction until the major market participants agree to standardize contract design and trading practices. In another move toward that goal, the Depository Trust & Clearing

Corp. in January said it would support all central clearing solutions with its trade information warehouse in a non-discriminatory way.

Efforts to standardize contracts are well under way. By early March, industry leaders expect to have made some significant changes in CDS contracts including establishing standardized coupons of 100 or 500 basis points; shifting to cash settlement from physical settlement; and changing effective dates to the trade date less 60 days. The industry is also working toward agreement on a standard auction process for settling trades and removing "restructuring events" as one of the triggers that require payment under the contract terms.

"Increasingly, now the whole industry has come to the same realization...that we really need to restructure the design of the product and make it so that it is more clearable, so that it can be netted and so that it can be more standardized," IntercontinentalEx-

change chief executive officer Jeffery Sprecher said in early February.

"The timeline is predicated on our work to solve a range of structural issues that, once resolved, will create a new risk management framework, enabling the credit industry to grow," said Sprecher, who made the comments during a conference call to discuss the exchange's quarterly earning results.

Another factor is the operational challenge in establishing connections between the central counterparties and market participants. Although the large banks that dominate the credit derivatives market have futures divisions that are fully integrated into the clearing process, credit derivatives are typically handled by a different division of the bank. Exchange officials say that it could take several more months before dealers and banks have completed their preparations to connect their systems to the clearinghouses.

"We have to be able to interface with the community of users who will be active with us and that will be the next step," said CME chief executive officer Craig Donohue in a conference call to investors on Feb. 3.

Pressure for a European Solution

Lawmakers and regulators on both sides of the Atlantic, frustrated by the slow progress, have threatened to take regulatory and legislative steps to ensure a migration to clearing for this bilateral market.

But the February commitment from leading CDS industry participants to clear qualifying contracts on a European platform by the end of July 2009 was welcomed by regulators in Europe. "This meets requests I made to the industry last October," McCreevy said of the commitment made by the nine firms—Barclays Capital; Citigroup Global Markets; Credit Suisse; Deutsche Bank; Goldman Sachs; HSBC; JP Morgan Chase; Morgan Stanley and UBS.

One reason for the dealers' willingness to make this commitment was to stave off the threat of increased capital charges. Pervenche Beres, chairwoman of the European Parliament's committee on economic and monetary affairs, had drafted an amendment to the EU capital requirements directive that would impose higher capital charges on banks that do not clear CDS trades in Europe. Anthony Belchambers, chief executive of the U.K.'s Futures and Options Association, has raised concerns about this change to the capital rules. "Where does that leave the tailored transactions, which don't lend themselves to a cen-

tral clearing system," he asked.

"We need to be careful with regulations with capital incentives. We want to make sure that they don't have perverse implications for the markets," warned Belchambers.

Regulatory Turf Battle in the U.S.

Concerns are also high in the U.S. where lawmakers are drafting laws that would vastly change how the OTC derivatives markets function.

"The failures of AIG, Lehman, Bear Stearns, and other institutions have shown us that it is time for some transparency in the market for credit derivatives," House Agriculture Committee Chairman Collin Peterson (D-Minn.) said in early February.

The lawmaker's bill, which passed the House Agriculture Committee and now must be considered by other House committees, would encourage the clearing of standardized

Yet another player in this game is the Securities and Exchange Commission. In late December the SEC granted exemptions allowing NYSE Liffe and LCH.Clearnet to offer CDS clearing through their Bclear service. The exemptions will expire in September, however, and they are subject to review under the agency's new head, Mary Schapiro, who has told U.S. lawmakers repeatedly that standardized CDS contracts must be cleared through regulated clearinghouses. "I absolutely believe that credit default swaps need to come under the umbrella of federal regulation," Schapiro told the Senate Banking Committee in January just days before being confirmed and sworn in to her post.

But efforts to better coordinate are being taken. U.S., U.K, and European regulators are in talks to jointly oversee the credit default swaps market and clearing in particular. "Representatives from regulatory agen-

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CDS contracts as a way to reduce systemic risk. Representative Peterson is adamant that any CDS clearinghouse or trading system should be regulated by the Commodity Futures Trading Commission, or the Securities and Exchange Commission but not the Federal Reserve.

"I'm flat-out opposed to the Fed having a role in clearing or overseeing these products," said Peterson in early February. "I share the concerns of those who think the Fed controls too much already. They are an unelected body that sets monetary policy, oversees its state member banks, oversees holding companies, and now they are printing money for the bailout. I am not surprised that the large banks are clamoring for the Fed to regulate derivative activity, given their cozy relationship with Fed members."

Peterson's view puts him in opposition to Representative Barney Frank (D-Mass.), the chairman of the House Financial Services Committee, and Tim Geithner, the new Treasury Secretary and former head of the Federal Reserve Bank of New York. Both Frank and Geithner believe the Fed should have a role in overseeing CDS clearing.

cies with direct authority over one or more of the existing or proposed credit-default swap central counterparties (CDS CCP) discussed today possible information sharing arrangements and other methods of cooperation within the regulatory community," the Federal Reserve said in a Feb. 19 statement.

Support in the Marketplace

Despite the regulatory and technical logjams, industry experts are confident that clearing will indeed be part of the CDS picture.

Risk managers at both buy-side and sell-side firms are eager to see clearing adopted so that their firms are better positioned to value portfolios and hedge against counterparty defaults.

"I think what we are seeing right now is a fear bubble and it's really driven in part by fear of counterparty default," said Robert Park, chief executive officer of Fincad, a Vancouver-based firm that provides derivatives analytics and valuation models to more than 3,500 banks, funds and other institutions including JPMorgan Chase, Deutsche Bank, Alliance Bernstein, Citadel Investments and Tudor Investment Corp.

"We've got this land grab rush going on between the various clearinghouse efforts and I think in general that's a very positive move," said Park predicting there would be one dominant clearinghouse in the U.S. and one in Europe.

Sophis, a software firm that specializes in portfolio and risk management solutions, recently conducted a survey of risk managers and derivatives traders. Half of the respondents indicated that at least 50% of their CDS trades will move from OTC to clearinghouses. "What we found was that across the board people were pretty convinced that something was going to be done from a standardization process whether it was going to be regulatory or operational," said Eric Bernstein, chief operating officer at Sophis.

He emphasized that NYSE Euronext's approach to clearing CDS will not "disintermediate" the dealers active in this market, in that the clearing service is not linked to trade execution. Regarding the structure of the clearinghouse—a key concern for clearing firms—Neiderauer said index-based CDS will rely on the existing guarantee fund, but he hinted at a different approach with single-name contracts.

"Even where the CDS market experiences extreme swings in volatility with a default of a major investment bank in September, the indices remained relatively liquid," he said. "We do not believe that this is the case with single names so a new guarantee fund may have to be established to support the clearing of that product."

revenue will be shared with partners based on submitted volume and 20% on cleared volume.

Eurex Promises User Say in Governance

Eurex has been less specific about its plans, but has emphasized that it wants to give market users control over how the clearing process operates. Credit derivatives will be cleared by a separate company under the governance of an independent board, and up to 90% of the board members will come from clearing firms, exchange officials said.

"From a regulator's perspective, central clearing is increasingly recognized as a key element of market integrity," said Uwe Schweickert, senior vice president at the Frankfurt-based Eurex.

Eurex plans to start with contracts linked to series 7, 8, 9, 10 and 11 of iTraxx Europe indexes. There is no timetable for clearing single-name contracts. While the goal is to roll out clearing by the end of March, the ultimate timing for the launch depends in part on what happens on the regulatory front, Eurex officials say.

Clearing members will have to provide a minimum contribution of 50 million euros. That contribution is dynamic dependent on the risk exposure of the clearing member, translating into 3% to 7% of margin requirement.

CME Awaits Regulatory Approval

The CME has received CFTC and Fed approval for the CMDX clearing platform that it is developing with Citadel, but as of early February the launch was still pending SEC approval.

"We are in advanced states of review by the SEC and continue to make progress there. We continue to work actively with market participants to demonstrate the advantages of our offering and have begun to work with those participants on operational readiness," said CME's Donohue.

Once all the approvals are in place, this system will be able to clear all credit default swaps, including single-name. On the first day of launch, CME says it will be set to cover 75% of the market, including more than 500 reference entities and 40,000 contracts. The CME will standardize these contracts to clear them, but they will remain as OTC contracts. This approach is used for other contracts, such as the Chicago Board of Trade ethanol swaps.*

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For NYSE Liffe, CDS is Just the First of Many

Duncan Neiderauer, the chief executive of NYSE Euronext, sees the debate over CDS clearing as just one part of a larger recognition that the trading of all OTC derivatives needs to be reformed. Credit derivatives will be just the first type of OTC contracts that the exchange hopes to bring onto the London-based NYSE Liffe Bclear service. This service is provided in partnership with LCH.Clearnet.

"It's clear to all of us that one of the repercussions of the financial crisis will be that many products that have been traded opaquely in relatively unregulated environments will be forced by regulators to migrate to more regulated transparent venues," he said on Feb. 9. "CDS is only the first of what I expect will be many OTC derivatives that move toward an exchange clearing model and represent a key area of future growth for us."

Neiderauer acknowledged that the take-up for CDS clearing on NYSE Liffe has been "slow or non-existent," but said a "slower ramping up was expected" due to the complexities of the product and the difficulties in getting members connected to the system.

NYSE Liffe officials say that they are aiming to clear single name contracts later this year, but say a number of technical details and risk issues need to be resolved first.

"There are all sorts of complicating factors from a risk perspective" said Simon Grensted, managing director of business development at LCH.Clearnet. "The problem for single name contracts centers around pricing, liquidity and 'jump to default' risks. There are quite a large number of credit derivatives which are not that liquid, and there are some quite interesting challenges in the ones that are liquid. The cost of margining and clearing has to be economically viable for the user."

NYSE Liffe also has structured its pricing scheme to attract volume. Fees are charged in proportion to the notional volume, with some fee caps set for larger trades. Each 1 million euros of notional value will be charged 10 euros, up to the following caps of 100 euros for proprietary business and 400 euros for client business.

NYSE Liffe is offering a 40% revenue scheme for early users of the system. Those firms who signed up prior to Jan 31 will be eligible to take part in the incentive scheme. Under that plan 20% of net

To help lure CDS participants, CME and Citadel will allow up to a 30% stake to be taken by those CDS market participants choosing to act as founding members. Transactions cleared through CME will be backed by its \$7 billion default fund, the largest of any counterparty in the world.

Margin requirements will be based on the risk in a portfolio with a model the CME has developed and will be designed to cover a 1 to 5 day move. Firms wishing to clear on the CME platform must have adjusted net capital of \$300 million and they must have set aside minimum Tier 1 capital of \$300 million. The minimum membership requirement deposit is \$5 million with an additional security deposit requirement.

ICE Stresses “Dialogue” with Dealers and Regulators

Meanwhile, ICE is working closely with the leading dealers to finalize its acquisition of The Clearing Corp. ICE’s Sprecher is adamant that the acquisition is conditioned upon regulatory approvals to run a clearinghouse. “We are very, very interested in acquiring The Clearing Corp. The reason it hasn’t happened yet is we are only interested in acquiring The Clearing Corporation if it

has a license to be able to clear CDS trades, so its closing is tied to our final regulatory approvals,” Sprecher said in an investor call after releasing ICE’s latest earnings.

Sprecher explained that what is underway now is more than just a routine application process. “What’s happened is there’s been an

One key advantage to the ICE system is that the major CDS dealers are already linked into the system through Creditex, which is owned by ICE and has conducted 40 portfolio compressions together with Markit since August. Sprecher warns though that even a good platform is of no use without structural

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interactive dialogue going on around the restructuring of the CDS industry and how some of these pieces come together. That ongoing dialogue involves many, many regulatory agencies [and] many, many market participants and our clearing and post-trade infrastructure is trying to get this put into place so that it can all be solved at the moment in time that this launches,” said Sprecher.

changes in the market. “I really feel like there’s a broad recognition in the market that the current product is broken... So while people are making money right now, there’s a general sense that it is not sustainable.” ■

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