CDS on Bclear - a safer, clearer route for OTC

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When former Federal Reserve Chairman Alan Greenspan acknowledges that he was "partially" wrong in his belief that some trading instruments, specifically credit default swaps (CDS), did not need regulation, it is time to take note.

Indeed, the subject of regulation and efficiency in the over the counter (OTC) credit derivatives market is now taking centre stage among financial regulators in the US and the EU. Increasingly concerned, New York Federal Reserve officials have recently held a number of meetings with key players in the highly liquid and sophisticated, multi trillion dollar CDS market. Able to offer the right balance between flexibility and the benefits provided by financial regulation, exchanges have proved central in these discussions to bring about a solution.

Growing at an unprecedented rate, there is no doubt that changes need to take place within the CDS market. The key issues in this market that need to be addressed are: reducing operational risk, managing counterparty credit risk, creating real time reporting and improving capital efficiency - quite a challenge.

Whilst clearing houses and exchanges will be key in achieving this, it is not expected that regulators will back any one CDS clearer, preferring instead that there is healthy competition in this marketplace and choice for users.

Liffe, the derivatives business of NYSE Euronext, will be the first exchange to offer a genuine CDS solution to tackle these issues. Launching on 22 December 2008, Liffe CDS will be provided via Bclear, a proven processing and clearing service that is already meeting the needs of the OTC market.

Since it was launched in 2005, Liffe's OTC derivatives service Bclear has been used extensively by leading investment banks and buy-side firms to process OTC business, helping them to reduce operational risk and manage counterparty risk. Bclear currently offers futures and options on an extensive range of equity derivative products and extending the risk management benefits of this service to the CDS market is a logical next step.

Liffe CDS contracts are true CDS contracts, rather than futures or options, and will offer the market a solution that will tackle some of the concerns related to operational and counterparty risk. CDS on Bclear will allow market participants to enjoy the benefits of doing business on an exchange - clearing, processing and margining facilities - whilst retaining the benefits and conventions of trading OTC.

CDS trades will still be pre-negotiated and agreed anonymously in the OTC market but they will then be processed via Bclear and cleared by the exchange and clearing house, LCH.Clearnet Ltd, who act as the buyer to every selling clearing member and the seller to every buying clearing member.

By bringing together the best elements of an exchange and clearing house with those of the OTC market, Liffe will be able to offer the market a very viable solution for CDS.

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