



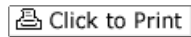
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Taming derivatives

Can the private sector clean up credit default swaps?

By [Telis Demos](#), writer reporter
October 30, 2008: 10:05 AM ET

(Fortune Magazine) -- It's conventional wisdom that credit default swaps - the \$55 trillion in derivatives contracts widely blamed for bringing down AIG - need oversight. But as Washington debates how to regulate what Senator Tom Harkin (D-Iowa) calls "casino capitalism," exchanges like the CME and NYSE are proposing their own free-market solution.

Companies that run exchanges are proposing to set up clearinghouses for these contracts. Within a week of each other in October, both the CME Group ([CME](#)), partnering with hedge-fund giant Citadel, and the Intercontinental Exchange ([ICE](#)) announced systems for clearing and settling CDS. By the end of the month, three more exchanges laid out competing plans.

Right now, in a typical CDS contract, an investor owning the bonds of a company might pay a premium to a bank to insure itself against that company's suffering a "credit event" (say, GM going bankrupt) that makes the bonds worthless. This contract might state how much collateral the bank would post if the company's creditworthiness slides. In the past, many contracts didn't require much in the way of collateral - hence the panic among investors when defaults began to loom.

To be sure, the CDS market has continued to function while commercial paper, for example, has shut down. When contracts tied to Lehman's bankruptcy were settled in late October, money was exchanged without a hitch. Even the U.K. government, when deciding how to value its stake in Royal Bank of Scotland ([RBS](#)), turned to the CDS market for pricing guidelines. But the way regulators and other critics see it, the uncertainty around CDS is the real problem.

Put in the middleman

Under the new plans, the clearinghouse would be the middleman. The bank in our example would have funds deposited at the clearinghouse, which would guarantee the bondholder gets paid if bankruptcy happens. Regulators would meanwhile gain a handle on the overall CDS market. "Our solution offers regulators the information and transparency they need to assess risk," Terrence Duffy, chairman of the CME, told lawmakers.

But banks have reasons not to embrace the idea. Clearinghouses may standardize CDS contracts; banks earn fees for customizing them. Determining how much collateral should change hands at a clearinghouse could also be a bone of contention.

These hurdles may result in banks' clearing their simplest CDS - primarily contracts tied to broader credit indexes rather than individual companies - but not their riskier, more complex ones. That group includes so-called "naked" contracts, in which the buyer of protection doesn't actually own the bond the contract is tied to.

"For certain types of standardized contracts, banks have all the incentives in the world," says Richard Lindsey, former head of trading services at Bear Stearns, and now an independent consultant with the Callcott Group. "The risk is if you want to buy CDS protection on more esoteric things, and there's no market for it."

The exchange companies offer different solutions to these problems. The CME wants to also trade CDS on a central platform, which would allow a market to determine contracts' prices, and thus how much collateral and daily margin is needed. But its partner in a potential exchange, Citadel, might scare away some banks. "People are competitors," says Lindsey. "Anything that's not a consortium slows adoption."



Vanilla

ICE, on the other hand, would allow banks to continue to negotiate contracts one-on-one, and to use market surveys - those provided by London data firm MarkIt, a partner in ICE's clearinghouse - to determine prices rather than an exchange. "Putting something on an exchange [doesn't] take into account the fact that there are some very legitimate needs for bespoke, customized, tailored swap products," said ICE general counsel Jonathan Short to lawmakers at the October panel. "One of the risks of [saying] you're only going to be able to eat vanilla ice cream is that it chokes off financial ingenuity."

That's why regulators want to stay involved. New York Fed president Tim Geithner, who has long lobbied for central clearing, has extracted informal promises from banks to participate. "We are going to be clearing through a central counterparty the vast majority [of CDS] within the next couple of months," says Eraj Shirvani, chairman of the International Swaps and Derivatives Association, which counts the banks as members. "Our commitment as an industry to establishing a central counterparty solution is absolutely rock-solid."


Harkin wants even more assurance. After his hearings in late October, he said he expected to introduce a bill that would mandate clearinghouses and set up central trading for credit default swaps. Congressman Collin Peterson (D-Minn.) told industry representatives at a House hearing the day after Harkin's Senate hearing: "Your folks need to get real if they think they're not going to get regulated."

Meanwhile, the exchanges are negotiating with banks about how to structure the system. As evidence of the way things can work, they point to the clearing of energy trading after Enron's collapse. "Clearing in that market is now a couple-hundred-million-dollar business for us, and it works beautifully," says Craig Donohue, CEO of the CME. If the Enron mess can be made beautiful, why can't credit default swaps? ■

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