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Contingency plans

CCDS trading platform prepares for launch

A new trading platform – Novarum Global Trading – is being prepared, offering contingent CDS (CCDS) protection to enable dealers to hedge unsecured counterparty credit risk. Furthermore, it is hoped that such trades will one day be novated through a central clearing house.

CCDS contracts – transactions with a third party that replace an existing CDS contract if an original counterparty fails – have been a subject of discussion for a number of years, although uptake of the product has so far been limited (see SCI issue 84). Indeed, those behind Novarum Global Trading platform have nurtured the idea of such a platform for many years, having initially begun discussions with US regulators five years ago.

However, mitigating counterparty risk is now a much higher priority for the industry in the current market environment. For example, Credit Derivatives Research's counterparty risk index (CRI) reached its highest level since 10 October 2008 last Friday, adding 20.2bp on the day and 57.1bp on the week.

All fourteen index members traded wider (more risky), with Citigroup wider by almost 20% on the day and over 50% on the week. Bank of America was 60% wider on the week, according to CDR analysts.

Shankar Mukherjee, co-founder of the Novarum Group, the firm behind Novarum Global Trading, says that the CCDS trading platform is essentially ready to go. "The technology, operational guidelines and corporate structure is already in place. We are currently in talks with a major rating agency, and we expect to get a strong investment grade rating," he says. Its launch is scheduled for later this year.

The Novarum Global Trading operating model will be distinct from that of CDPCs, SIVs and traditional monoline financial guarantors, as its risk practice will be based upon the continuous replication and decomposition of all market and credit risks into plain vanilla OTC derivative products. In addition, all CCDS and associated hedge transactions will be executed under a fully margined credit support annex to mitigate any counterparty credit risk to Novarum Global Trading.

Novarum's founders – ex-Citigroup employees that include Mukherjee, Andrew Hollings and Svein Stokke – are also all in favour of the push for centrally-cleared CDS. But, while the clearing houses will focus on inter-bank CDS trades, Novarum will be looking to address trades that are difficult to margin – namely unsecured counterparty credit risk.

"Novarum is already fully margined to carry out bilateral trades, but we also believe that the clearing house initiatives are highly complementary to what we do," says Mukherjee. "When the clearing houses have the ability to clear CCDS trades, Novarum would be happy to novate existing bilateral trades to the clearing house if the customer requests it."

Meanwhile, the debate around central clearing for CDS continues (see separate News story). The establishment of a central counterparty for CDS is expected to drive the CDS/cash basis tighter by reducing counterparty risk, as well as spurring further deleveraging in the market.

"Deleveraging will be aided by the establishment of a double layer of margins (from dealer and clearing house), as well as by reduced pressure on heavily-bid product as investors become used to unlevered returns and – by paying upfront – CDS contracts will also be less levered," explains one structured credit investor. "Ultimately, in some respects CDS could end up behaving more like cash bonds due to all of the improvements being made to the market's infrastructure."

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