

**Larry Fondren**  
DelphX, LLC

27 January 2016

## Single-Name CDS Market Needs a Reboot

*Revival of a robust single-name CDS market would offset the lack of liquidity in the cash bond market, increase price transparency and lower the cost of financial risk management for all participants. But the market needs a more efficient way to manage single-name CDS capital exposure.*

Revival of a robust single-name CDS market would offset the lack of liquidity in the cash bond market, increase price transparency and lower the cost of financial risk management for all participants. Central clearing of CDS will reduce counterparty risk and could help revive interest, but it's more expensive than bilateral trading. Innovation is needed to address the increasing concern around flagging liquidity in both cash bonds and derivatives. To achieve this, the market needs a way to offset the capital strain and notional exposure of CDS positions.

Intermediating liquidity in the credit markets requires dealers to carry inventories of risky securities. To manage that risk, dealers employ a variety of hedging protocols, including CDS contracts, which transfer risk to other counterparties. Single-name CDS contracts enable the buyer to hedge risk and mitigate losses due to the default of a specific corporate, municipal or sovereign issuer – precisely aligning the protection with a credit event.

Regulatory changes in response to the financial crisis have increased dealer capitalization requirements, subsequently raising the cost of holding bonds. As a result, dealer inventories have declined, diminishing dealers' ability to provide liquidity. This is especially true for corporate debt, where dealer corporate bond inventories have vastly fallen since the 2008-2009 credit crisis, even as the size of the corporate market has grown significantly.

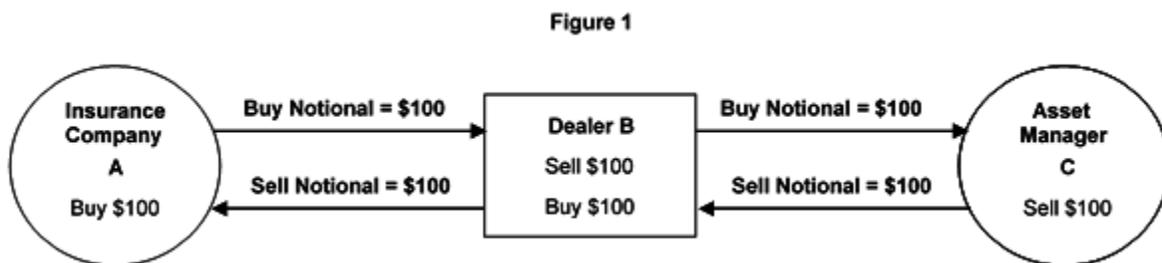
When the Depository Trust and Clearing Corporation ([DTCC](#)) began tracking CDS trading in 2008, net transactions in single-name CDS totaled \$1.59 trillion. In 2015, net volumes have plummeted to \$646 billion as post-crisis regulation and capital constraints now limit dealer leverage ratios and their ability to hold material inventories.

Proponents of central clearing of single-name CDS trading highlight the significant reduction in counterparty exposures such clearing would provide. In the Federal Reserve Board FEDS

Note, [Estimating the Effect of Central Clearing on Credit Derivative Exposures](#), the counterparty exposures of current bilateral CDS transactions is described as follows:

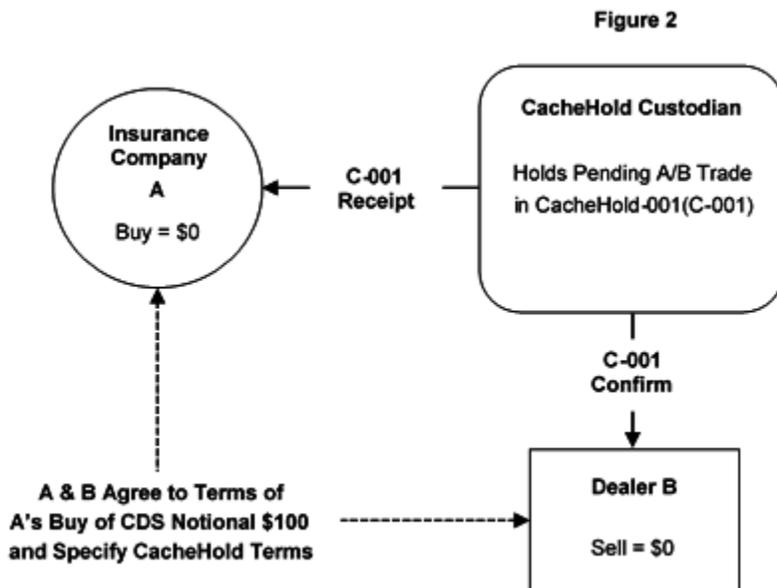
*“Consider two distinct, hypothetical CDS transactions. In the first transaction, a large derivatives dealer sells \$100 of CDS protection, to insure against the default of a corporate bond issuer, to an insurance company. In the second transaction, the same dealer purchases \$100 of CDS protection from an asset manager.”*

The dealer is a direct counterparty to both transactions, each of which have a buy and a sell leg, resulting in total capital exposure of \$400.

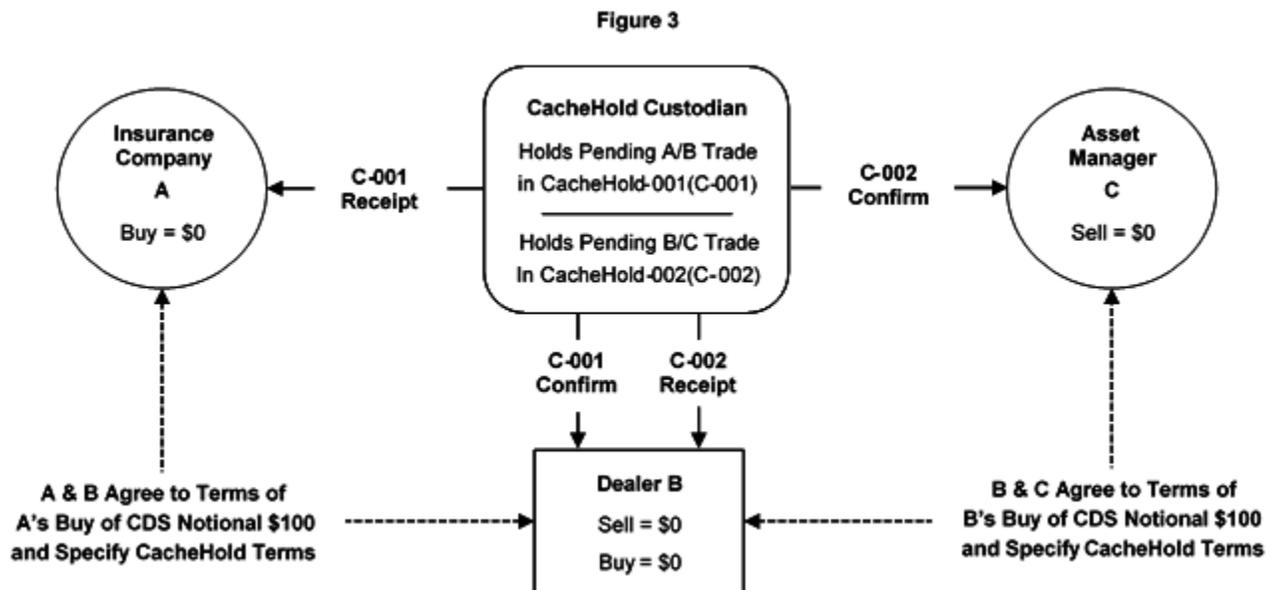


### A Better Way

We believe there is a much more efficient way to manage single-name CDS capital exposure. Imagine that the insurance company A and the dealer confidentially negotiate the terms of a bilateral CDS contract for a given reference entity and then postpone execution of that contract until the buyer in the pending transaction (A) elects to proceed. The pending transaction is then placed in a “CacheHold” maintained by a large third-party custodian and managed in accordance with the terms specified by the pending counterparties. The Custodian then issues the sole “CacheHold Receipt” (“CR”) for C-001 to A as the CacheHold buyer.



To replicate the combination of transactions outlined in Figure 1, we'll imagine that the dealer also concurrently negotiates a bilateral CDS contract with asset manager C, in which the dealer buys protection on the same reference entity. Thus in the combined transaction depicted in Figure 3, below, the dealer intermediated binding CDS protection between an insurance company and an asset manager with total notional exposure of the combined transaction equaling \$0.



While the holder of a CR can redeem it at any time, triggering the contractual release and execution of the pending CDS trade, the holder will likely have no incentive to redeem the CR unless and until a default involving the reference entity has occurred.

In its [2014 Global Default Rate Summary](#), Standard & Poor's reports the highest default rate during the period 1981 through 2014 for investment-grade corporate bonds was 0.42% (in 2002 and 2008) and 11.05% (in 1991) for speculative grade issues.

Through the use of negotiable CRs, the industry could:

1. Dramatically reduce the notional exposure of single-name CDS;
2. More efficiently hedge risk and mitigate losses;
3. Dynamically adjust current and future default protection based upon future credit risk of reference entity; and
4. Strategically redeem only those CRs for CDS contracts upon which a related credit event has occurred.

## Comments |

2 Comments to "Single-Name CDS Market Needs a Reboot":



**Anonymous**

28 January 2016

We have known for years now that the cost of dealer of "dealer inventory" has risen to the point where trading in many names is no longer viable. Until that cost reduces "dealer inventory" remains the limitation on solving the liquidity problem.

Is there an alternative to "dealer inventory"?



**Ifondren**

28 January 2016

Anonymous - Thank you for your comment regarding the need for reducing the cost of "dealer inventory". While the need for dealers to hold inventory will continue to be essential to their cost-effectively intermediating on-demand liquidity, I believe there are several alternative ways in which dealers can hold those required inventories at a materially lower cost.

The "CacheHold Receipts" described in the post above dramatically reduce the CDS inventory a dealer must hold to provide robust liquidity in the single-name CDS market. As a result, their corresponding net cost of holding such inventory significantly reduces.

To reduce the cost of dealers' cash bond inventories, my firm also developed the "Cached Inventory" protocol, which enables dealers and other market makers to negotiate binding future transactions with investors, and then contractually hold those pending transactions in a confidential Cache maintained within our DelphX network. Thereafter, the applicable market maker can release agreed portions or all of the Cached Inventory as needed during the specified cache-period to intermediate vast on-demand liquidity in the OTC market.

I'd be pleased to arrange a demonstration of either or both of the described caching facilities at your convenience.

Thanks.