CDS on Bclear

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Liffe CDS – Status

- The only CDS clearing solution live today

- Regulated by the FSA in London, exemptive relief by the SEC in the US

- Key agreements already in place with ISDA and Markit

- Products fully cleared by LCH.Clearnet Ltd.

- Leading with iTraxx, product roll-out schedule includes CDX and liquid single names

- Revenue sharing scheme put in place – scheme closed on 30 January with 31 major banks and brokers registered
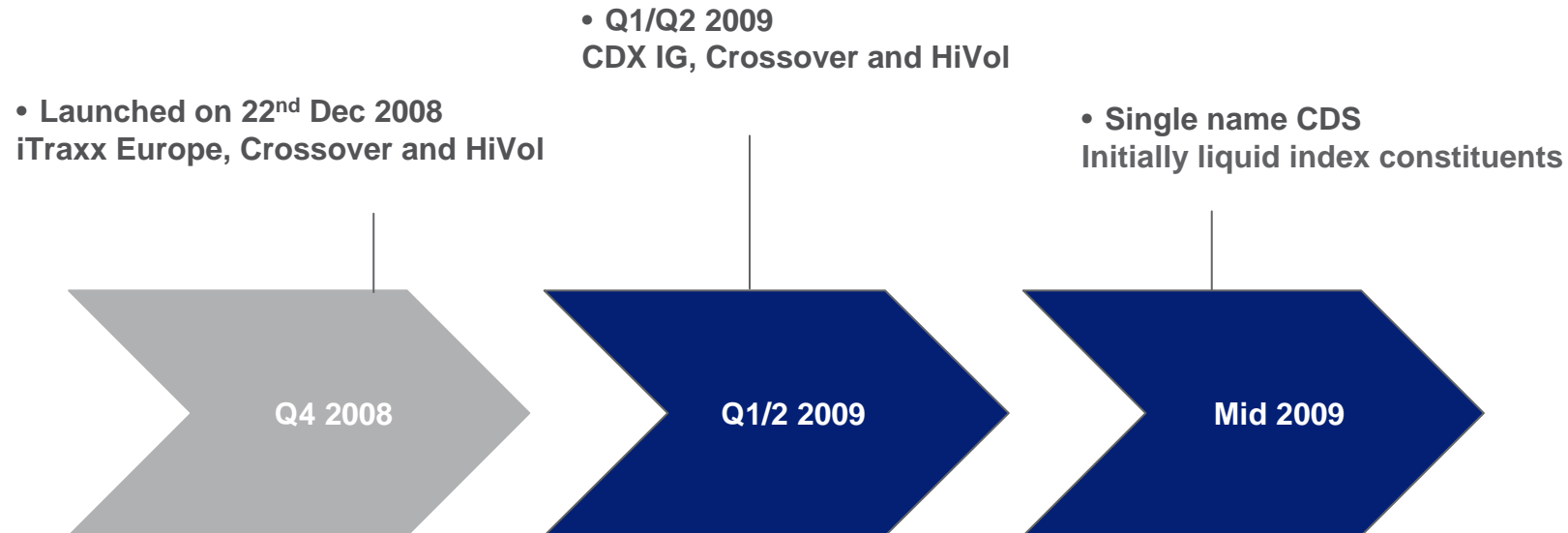
Liffe CDS – Market Structure

- A pre-negotiated and truly multilateral market

- Move in and out of a position with multiple counterparties, facing off against LCH.Clearnet Ltd.

  – Standardising and greatly reducing counterparty risk

- Daily compression of all trades into a single net position, as per LCH SwapClear

  – Greatly reducing notional outstanding

- Efficient margining, freeing up balance sheet capital

  – Using systems already present in all the main broker-dealers

- Account segregation, allowing customer accounts to be isolated from dealer positions

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Liffe CDS – A Standardised Contract

- Liffe credit default swaps reference ISDA 2003 credit event definitions, and cash settle into the results of ISDA credit event auctions

- In order to deliver a true multilateral centrally cleared environment, our approach features additional standardisation:

  – A defined determinations process for credit events, to which all contracts are bound

  – Automatic application of subsequent ISDA updates and amendments to existing contracts

  – Cash settlement for all contracts, with a facility for physical settlement when pan-European settlement infrastructure will allow

- This standardised multilateral approach allows trading with a wider range of counterparties, even **without** ISDA bilateral agreements

- Our member relationships and account structure fully support the sell and buy side

Liffe CDS – Proposed Product Timeline

• **Q1/Q2 2009**
CDX IG, Crossover and HiVol

• **Launched on 22nd Dec 2008**
iTraxx Europe, Crossover and HiVol

• **Single name CDS**
Initially liquid index constituents

Q4 2008

Q1/2 2009

Mid 2009

Other contracts will be considered according to customer demand

(e.g. index tranches, sovereign CDS)

Liffe CDS – Credit Event Determinations

- For a multilateral centrally cleared environment, a binding credit event decision process is essential

- Determinations for Liffe cleared contracts will be made by an independent credit event Adjudicator:

  - A leading financial (QC) Senior Lawyer appointed by Liffe to make an independent determination

  - Decisions will be based on the existing ISDA concepts of Publically Available Information, the facts of the potential credit event, issuance of ISDA protocols, and other market events

  - Liffe Clearing Members (typically major CDS broker/dealers) will be able to participate in a Market Advisory Group (MAG) call to present additional facts to the Adjudicator

  - The Adjudicator's Terms of Reference have been specifically developed to minimise the risk that a decision would diverge from market consensus

  - Full details are available in Liffe's contract documentation

- We stand ready to adopt universal market determinations when they become available, and strongly encourage the development of such standards

LCH.Clearnet – Key Points

- LCH.Clearnet is a global leader in clearing, with particular strength in OTC markets and the rate swaps clearing service. LCH.Clearnet clears business in 17 currencies

- LCH.Clearnet is subject to the Settlement Finality Directive, and will comply with the ESCB-CESR recommendations when these are finalised

- LCH.Clearnet has significant user involvement in material decisions, and its Risk Committee (which has user involvement) has reviewed and approved the CDS products.

- Access criteria are solely based on the financial and credit standing of the potential member. For CDS Index products these are the same as those for other exchange traded derivatives.

- The Liffe CDS product can be integrated to the existing DTCC Trade Information Warehouse, and a model for doing this has been designed in consultation with DTCC

- A mechanism for backloading of CDS positions is under development. LCH.Clearnet has significant experience of backloading swaps positions, based on its existing swaps products.

- LCH.Clearnet's stability and resilience has been proven by its record of successfully managing member defaults, and in every case within the Initial Margin of the defaulting firm. Segregation of house and customer positions is standard for exchange traded derivative markets

- LCH.Clearnet Ltd is open at all days and times stipulated in the Target 2 calendar

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LCH.Clearnet - Risk Management

- LCH.Clearnet will carry out risk management of CDS Index products using the same proven framework as other exchange traded, OTC and Liffe products

- This framework for managing counterparty risk has been tried and tested and most recently utilised during the default of Lehman Brothers in September

- The following are the key instruments used for risk management:

  – Membership Criteria

  – Variation Margin

  – Initial Margin

  – Intra-day Margin

  – Default Fund

LCH.Clearnet – Default Management

- LCH.Clearnet focuses extensively on default management, and utilised this tried and tested process during the management of the Lehman Brothers International and Lehman Brothers Special Financing defaults

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┌─────────────┐   ┌─────────────┐   ┌─────────────┐
│ Apply Macro │   │  Transfer   │   │Close residual│
│ Hedges, as  │   │  customer   │   │  positions,  │
│  required   │   │positions to │   │individually or│
│             │   │ other CMs,  │   │via a portfolio│
│             │   │  wherever   │   │   auction    │
│             │   │  possible   │   │              │
└─────────────┘   └─────────────┘   └─────────────┘
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- This process enables business as usual for the remaining clearing members, while protecting customers of the defaulting member wherever possible.

- LCH.Clearnet is the only CCP with a highly formalised process for OTC products through the SwapClear service for Interest Rate Swaps

- This involves significant member participation in the hedging and auction activities; this process was tested during LBSF default, for a $9 trillion portfolio, and resulted in significant collateral being returned to the administrators

- As the CDS service expands we will continue to evaluate the default management process, with a potential to introduce a more formal auction process similar to that used for SwapClear