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Brussels, 17 February 2009

*Dear Commissioner,*

***Subject: European Central Clearing for Credit Default Swaps***

The European Banking Federation (EBF)<sup>1</sup> **supports the establishment of one or more central counterparties (CCPs) in the European Union (EU)** to facilitate the clearing of CCP-eligible Credit Default Swaps (CDS) and indices based on these entities, and the back loading of existing outstanding contracts.

European banks, active in the derivatives market as buy-side and sell-side participants, are currently **engaged in discussion with vendors of CCP services with regards to specification**, governance and the timelines to be able to establish the CCP. The sell-side and the buy-side are also currently discussing subsequent connections to the European CCP(s), to then be in a position to clear new CDS through the CCP and back load outstanding eligible CDS contracts in the market.

*Key considerations*

In terms of the product, credit derivatives, in particular credit default swaps (CDS), continue to be **a key instrument for efficient and flexible credit-risk management**. The introduction of CCP clearing for a significant portion of the credit derivatives can help to significantly reduce the systemic risks involved by reducing counterparty risks and increasing transparency.

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<sup>1</sup> Set up in 1960, the European Banking Federation is the voice of the European banking sector, with over €30,000 billion assets and 2.4 million employees in 31 EU and EFTA Member States. The EBF represents the interests of some 5,000 European banks: large and small, wholesale and retail, local and cross-border financial institutions. Since the vast majority of securities business in Europe is carried out by banks, the EBF is an authoritative voice on the evolution of financial markets in general and securities business in particular.

In terms of the infrastructure, it is important to note that, like the European Commission, **the Federation remains agnostic as to its ownership and location within the European Union.** European banks seek to reassure themselves that any and all CCPs that set themselves up in Europe to clear CDS are safe, sound, efficient and reliable, and above all meet the users' requirements in terms of technical specification and governance. The CCPs should of course be overseen by European regulatory authorities, who have, given recent market events, a legitimate expectation of information flow from the CCP in relation to the accumulation of counterparty credit risk.

A necessary prerequisite for CCP clearing is a high degree of standardisation of those types of CDS that are to be included. However, only certain types of CDS are susceptible to such standardisation (e.g. index related CDS or single name CDS on highly liquid names). These constitute a significant portion of the total volume of the CDS trade. However, certain types of CDS are by nature not eligible for CCP clearing. Consequently, **it will not be possible to introduce CCP clearing for the entire CDS market - eligibility criteria for CCP clearing should remain therefore a paramount consideration in the establishment and subsequent capital treatment of the CCP.**

#### *User requirements for CCP clearing of CDS in Europe*

To facilitate the establishment of one or more European CCPs for CDS, **the EBF has been in close contact recently with the European Central Bank (ECB) to assist it in setting up two meetings on this subject.** The first meeting on 13 February gathered those European banks with a specific interest in the European CCP and established a common set of user requirements for prospective CCP(s). A summary of the key issues that were discussed in that meeting is attached in annex.

At the second meeting, scheduled for 24 February, **the EBF will present the conclusions of the first, thereby initiating an open discussion between vendors and their potential customers.** Encouragingly, there appears to be a good deal of congruence between the requirements expected of the CCP by both buy and sell sides and the European System of Central Banks (ESCB), as expressed in the ESCB-CESR Recommendations.

#### *Capital treatment of CDS*

**The EBF has also taken note of recent statements regarding the European Commission's intention to regulate CDS.** The current focus is of course on the revision of the Capital Requirements Directive (CRD) and the five amendments that have been proposed to affect the capital treatment of CDS cleared in Europe going forward.

The proposed amendments to the CRD propose a **zero percent risk weighting CCP cleared CDS, which the Federation welcomes.** They also propose applying punitive capital charges for those contracts not cleared through CCPs. **European banks have identified a number of significant risks to the common European interest that could**

result from the proposal currently in the European Parliament,<sup>2</sup> to introduce punitive capital charges. The risks relate predominantly to the competitiveness of Europe's financial markets and the potential impacts of the amendments on SME financing. Furthermore, the amendments would have a significant impact on efficient risk mitigation in many areas, including synthetic securitisation.

We would therefore **urge the European Parliament to reconsider the CRD amendments** in relation to the punitive capital charge for CDS not cleared through CCPs. At the very least a distinction should be made between CDS eligible for CCP clearing and those which are by their nature not eligible for CCP clearing but nevertheless serve as a risk mitigation instrument.

We would also ask European law makers to take into account the significant engagement of banks in this process and the recent announcements from CCP providers which all clearly point to **rapid, tangible and consensual progress now being made in this area.**

#### *Conclusions*

In this letter I have identified a range of considerations that would need to be taken into account before banks will be in a position to use European CCP(s) for CDS clearing. I would also urge you to carefully consider the impact of the amendments to the CRD currently in the European Parliament in relation to CDS for the reasons outlined above. I would nonetheless like to assure you of **the commitment of the EBF and its members to the creation of a European CCP for the clearing of Credit Default Swaps** and to be able to bring this into being against a tight timetable.

I copy this letter to the Chair of the Economic and Monetary Affairs Committee in the European Parliament, Mme. Pervenche Berès MEP, Mr Miroslav Kalousek, Chair of the ECOFIN Council and Minister of Finance of the Czech Republic and to Mrs. Gertrude Tumpel Gugerell, member of the Executive Board of the ECB. Should you wish to follow up on any of the points I raise here, and/or discuss the issues further, I remain at your entire disposal to do so.



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<sup>2</sup> Amendment 2 and connected amendments of the CDS package for the CRD.

## Annex

During the meeting of 13 February at the ECB on the creation of European CCP(s) for CDS, users identified the following requirements as being particularly important:

- The CCP should be subject to the **Settlement Finality Directive and the ESCB-CESR Recommendations**.
- **Appropriate representation of users in the governance** of the CCP and **appropriate consultation** with regard to material decisions.
- **Access criteria should be objective, non discriminatory, risk based** (according to capital) and designed so as not to deter the access of smaller European players. Migration to CCP clearing could also take place in a risk-based way provided it was conducted with due regard to the safety and soundness of the system.
- Appropriate **link between CCPs and data warehouse(s)**, leveraging existing facilities as far as possible.
- The possibility to **interoperate** with other CCPs performing similar functions around the world.
- However, if interoperability is to be achieved, CCPs should avoid competing on **risk management** grounds and there will be a number of risk management issues which will need to be addressed before interoperability becomes a real possibility.
- Ability to allow **back loading existing contracts**.
- Appropriate framework to ensure stability and resilience of the CCP, including the issue of appropriate **access to central bank liquidity, measures to separate accounts, funds and collateral and other measures to contain the effects of a default**.
- Ability to clear **in multiple currencies**.
- The CCP should follow the **TARGET2 calendar and opening times**. The EU based CCPs, and CCPs located in third countries, should open accounts with each other in order to enable them to close the positions cleared by them.