

**TESTIMONY OF THOMAS BOOK,  
MEMBER OF THE EXECUTIVE BOARD,  
ON BEHALF OF EUREX CLEARING  
BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES  
COMMITTEE ON AGRICULTURE**

**DECEMBER 8, 2008**

I am Thomas Book, a member of the Executive Boards of Eurex and Eurex Clearing. Chairman Peterson, Ranking Member Goodlatte and Members of the Committee, I appreciate this opportunity to testify before you today and I thank the Committee for calling this hearing on the important subject of over-the-counter (“OTC”) derivatives, particularly credit default swap (“CDS”) contracts, the role that they play in the United States and international economies, and the appropriate regulatory framework going forward, particularly as it relates to clearing of CDS contracts. As a member of the Executive Boards of Eurex as well as Eurex Clearing, I have overall responsibility for the management of the clearing business.

*1. Eurex and Eurex Clearing*

Eurex is one of the largest derivatives exchanges in the world today and is, in fact, the largest exchange for Euro-denominated futures and options contracts. While it is headquartered in Frankfurt, Germany, Eurex has 398 members located in 22 countries around the world, including 76 in the United States. Eurex, and its subsidiary the International Securities Exchange, a stock options exchange located in New York City, is part of the Deutsche Börse Group which also includes the Frankfurt Stock Exchange and Clearstream.

Eurex Clearing was formed in 1997 to function as the clearinghouse for the Eurex exchanges.<sup>1</sup> Eurex Clearing acts as the central counterparty (“CCP”)

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<sup>1</sup> Eurex Clearing AG is a stock corporation formed and incorporated under the laws of Germany and is a wholly owned subsidiary of Eurex Frankfurt AG, a German stock corporation which is itself wholly owned by Eurex Zürich AG, a Swiss stock corporation. Eurex Zürich has two 50% parents, Deutsche Börse AG, a German stock corporation listed on the Frankfurt Stock Exchange, and the SIX Swiss Exchange.

Eurex Clearing exists as a separate corporate legal entity from its affiliates for which it functions as CCP and has its own board of directors. As provided under German corporate law, Eurex Clearing has an Executive Board which is responsible for the day-to-day management and operations of Eurex Clearing, and a Supervisory Board.

for all Eurex transactions and guarantees the fulfillment of all transactions in futures and options traded on Eurex. Eurex Clearing does not currently operate directly in the United States.<sup>2</sup> Eurex Clearing is directly connected with various national and international central securities depositories, thereby simplifying the settlement processes for its clearing members. As Europe's largest and one of the world's leading clearing houses, Eurex Clearing clears more than 2 billion transactions each year.

Members of Eurex Clearing are categorized as either Direct Clearing Members or General Clearing Members. General Clearing Members, which number 58 firms, are the only clearing members who may clear transactions on behalf of nonaffiliated non-clearing members and most Eurex members in the U.S. clear their trades through them. General Clearing Members must have at least €125 million (approximately \$156 million) in equity capital. Credit institutions, banks, and other financial institutions that are regulated by a country in the European Union or Switzerland may become clearing members. Accordingly, Eurex Clearing has no clearing members located in the United States.

Eurex Clearing provides fully automated and straight-through post trade services for derivatives, equities, repo, and fixed income transactions with a track record of 99.99% availability of its electronic clearing platform. It also has strong financial safeguards and industry leading risk management, including in particular its unique risk functionalities and processes for derivatives such as intra-day risk margining in real-time based on actual positions and prices throughout the trading day and its integrated pre-trade risk validation functionality. It has a deep and experienced risk management team with in-depth knowledge of the latest risk models and techniques, including Value-at Risk Valuation models. Eurex Clearing has very strong lines of defense, including an overall collateral pool as of November 2008 of more than €70 billion and the highest collateral standards. It requires that overnight margin payments be made through central bank money.

Eurex Clearing has already established clearing and risk management procedures for credit futures based on iTraxx indices. These contracts were launched on Eurex in March 2007, making Eurex the first regulated market globally to offer credit derivatives. Eurex Clearing is currently working to expand its clearing services to include OTC CDS contracts that are registered in the DTCC Trade Information Warehouse. As explained more fully below, Eurex

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Eurex Clearing also acts as the central counterparty for and guarantees transactions on Eurex Bonds (a cash market for bonds), Eurex Repo (repurchase agreements), for equities on the Frankfurt Stock Exchange and the Irish Stock Exchange and for certain contracts executed on the European Energy Exchange. Transactions on the ISE, a wholly owned U.S. subsidiary of Eurex (through its U.S. subsidiary, U.S. Exchange Holdings, Inc.) are cleared by the Options Clearing Corporation.

<sup>2</sup> Eurex Clearing does, however, have an agreement with The Clearing Corporation relating to the operation of a clearing link between Germany and the United States.

Clearing believes that providing for a CCP with respect to such transactions will increase transparency in these markets, enforce strict risk controls and increase efficiency, thereby greatly reducing systemic risk for financial markets as a whole.

## 2. *Regulation of Eurex Clearing*

As required, Eurex Clearing is licensed as a CCP by the German Federal Financial Supervisory Authority (“BaFin”). In addition, on January 16, 2007, Eurex Clearing was recognized by the United Kingdom’s Financial Services Authority (“FSA”) as a Recognized Overseas Clearing House (“ROCH”), on the basis that the regulatory framework and oversight of Eurex Clearing in its home jurisdiction is comparable to that of the FSA.

The German Banking Act (“Banking Act”) provides the legal basis for the supervision of banking business, financial services and the services of a CCP. The activity of credit and financial services institutions is restricted by the Banking Act’s qualitative and quantitative general provisions. These broad, general obligations are similar to the Core Principles of the Commodity Exchange Act which apply to U.S. Derivatives Clearing Organizations (“DCOs”). A fundamental principle of the Banking Act is that supervised entities must maintain complete books and records of their activities and keep them open to supervisory authorities. BaFin approaches its supervisory role using a risk-based philosophy, adjusting the intensity of supervision depending on the nature of the institution and the type and scale of the financial services provided.

BaFin may grant a clearing license subject to conditions consistent with the Banking Act’s general provisions and may limit the scope of the license to certain types of business. When licensing an institution, BaFin issues guidelines to the institution with respect to capital adequacy and risk management and subsequently, it monitors compliance with the conditions for granting the license.

The Banking Act requires that a CCP must have in place suitable arrangements for managing, monitoring and controlling risks and appropriate arrangements by means of which its financial situation can be accurately gauged at all times. In addition a CCP must have a proper business organization, an appropriate internal control system and adequate security precautions for the deployment of electronic data processing. Furthermore, the institution must ensure that the records of executed business transactions permit full and unbroken supervision by BaFin for its area of responsibility.

BaFin has the authority to take various sovereign measures in carrying out its supervisory responsibilities. Among other things, BaFin may issue orders to a CCP and its Executive Board to stop or prevent breaches of regulatory provisions or to prevent or overcome undesirable developments that could endanger the safety of the assets entrusted to the institution or that could impair the proper

conduct of the Cap's banking or financial services business. BaFin may also impose sanctions to enforce compliance. BaFin has the authority to remove members of the Executive Board of an institution or, ultimately, to withdraw the institution's authorization to do business.

In addition, the German Federal Bank ("Deutsche Bundesbank") coordinates and cooperates, with BaFin, the primary regulator, in the supervision of Eurex Clearing. Deutsche Bundesbank plays an important role in virtually all areas of financial services and banking supervision, including the supervision of Eurex Clearing. Under the Banking Act, Deutsche Bundesbank exercises continuing supervision over such institutions, including evaluating auditors' reports, annual financial statements and other documents and auditing banking operations. Deutsche Bundesbank also assesses the adequacy of capital and risk management procedures and examines market risk models and systems. Deutsche Bundesbank adheres to the guidelines issued by BaFin. As appropriate, Deutsche Bundesbank also plays an important role in crisis management.

Both supervisory authorities use a risk-based approach to oversight. Under this risk-based approach, the supervisory authority must review the supervised institutions' risk management at least once a year, to evaluate current and potential risks and, in so doing, to take account of the scale and importance of the risks for the institution and of the importance of the institution for the financial system. Institutions classified as of systemic importance, including Eurex Clearing, are subject to intensified supervision by both supervisory authorities.

### 3. *Benefits of CCP Clearing for CDS Transactions*

In previous hearings<sup>3</sup> this Committee heard witnesses express concerns about the role that credit derivatives have played in the recent market turmoil. In this regard, witnesses cited the difficulties experienced by CDS contract writers that did not have adequate collateral to support their positions,<sup>4</sup> the lack of transparency with respect to such transactions,<sup>5</sup> the operational weaknesses in the current market structure,<sup>6</sup> and the systemic risk arising from these

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<sup>3</sup> To Review the Role of Credit Derivatives in the U.S. Economy: Hearing before the House Committee on Agriculture, 110<sup>th</sup> Cong, 2d Sess. (October 15, 2008 ) and To Review the Role of Credit Derivatives in the U.S. Economy: Hearing before the House Committee on Agriculture, 110<sup>th</sup> Cong, 2d Sess. (November 20, 2008).

<sup>4</sup>To Review the Role of Credit Derivatives in the U.S. Economy: Hearing before the House Committee on Agriculture, 110<sup>th</sup> Cong, 2d Sess. (October 15, 2008 ) (statement of Robert Pickel, CEO, International Swaps and Derivatives Association, at p. 3).

<sup>5</sup> *Id.* (statement of Erik Sirri, Director of Trading and Markets, U.S. Securities and Exchange Commission, at p. 6).

<sup>6</sup> *Id.* (statement of Walter Lukken, Acting Chairman, U.S. Commodity Futures Trading Commission, at p.3).

transactions and from interconnections between the market for CDS transactions and other markets.<sup>7</sup>

Eurex Clearing, like many of the witnesses before this Committee, believes that CCP services for CDS contracts will address the concerns identified before this Committee with respect to counterparty risk, lack of transparency regarding exposures and the sufficiency of risk coverage and operational weaknesses, thereby ameliorating systemic risk for the financial market. Given the huge exposure in CDS contracts and the systemic relevance of CDS clearing services in mitigating these concerns, a robust, proven clearing house is required to act as the central counterparty to these trades.

First, clearing of OTC CDS contracts by a CCP will reduce risk. The specific risks of CDS contracts with contingent liabilities that arise only upon the default of the contract's reference entity and the dual risks of a default of the reference entity and the subsequent default of the protection writer before settlement, require an independent, neutral and strongly collateralized CCP with a proven risk management capability.

Specifically, multilateral netting by the CCP would reduce the huge bilateral credit exposures arising from the current market structure. A central clearing house replaces multiple bilateral credit risks with the standard and transparent credit risk of the CCP. Moreover, and perhaps most critically, a CCP provides post-default backing, and by mutualising potential counterparty default risk, central counterparty clearing will ameliorate one of the most glaring systemic risks raised by the current market turmoil. Mutualising counterparty risk results in enhanced certainty with respect to legal enforceability and lines of defense in case of a default by a clearing member.

Second, clearing of OTC CDS contracts by a CCP will increase the transparency of position risk. Valuation of the risk of the netted positions is made by the CCP, an independent and market neutral party. The CCP requires that this risk be collateralized under a fully transparent and robust framework. Moreover, the collateralization framework, which includes daily mark-to-market of risk, provides an early warning mechanism with respect to the overall ability of parties to carry the risk of their positions.

Finally, central counterparty clearing addresses current operational weaknesses through standardized, straight-through processing. In this regard, multilateral netting of transactions reduces the complexity of back office processes and the number of fails and the CCP will simplify trade assignments.

Novation and netting procedures are already an integral and proven service of Eurex Clearing. Eurex Clearing believes that offering these services, which have a proven track record with respect to listed derivatives, will bring

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<sup>7</sup> *Id.*(statement of Erik Sirri,at p.2).

significant benefits to the OTC market in CDS transactions and, for the reasons discussed above, reduce systemic risk to the financial market and increase market integrity.

#### 4. *Description of Eurex Clearing's initiative for CDS clearing*

Eurex Clearing's new clearing service for OTC CDS contracts will address a significant part of global trades that exist bilaterally today and are registered in the DTCC Trade Information Warehouse, with the first priority on CDS index contracts. Highlights of this clearing service are:

- Product scope includes iTraxx<sup>®</sup> and CDX<sup>®</sup> indices, to be followed by iTraxx/CDX tranches and single name CDS
- Link with DTCC's DerivServ Trade Information Warehouse, ensuring full compatibility with existing CDS backoffice infrastructure and allowing automated backloading of existing transactions
- Credit event handling and settlement based on ISDA dispute resolution language and auction results
- Segregated guarantee fund for CDS to avoid commingling of risks and a separate clearing license
- Product specific, asymmetric margining concept designed especially to address CDS risk profile, and
- CDS risk management operated by Eurex Clearing with open access to eligible credit institutions; a separate entity to share governance and control with respect to product scope will be established.

For the clearing of CDS, a new clearing license from Eurex Clearing will be required. Only CDS clearing members will be permitted to submit CDS trades for their own account as well as their clients' accounts for clearing. Eurex Clearing will provide, among other things, the following services – corresponding to its clearing of non-CDS contracts – to its clearing members:

- Position keeping, separated for clearing members and their customers
- Daily position valuation
- Performance guarantees, and
- "Margin" requirements to cover members' potential losses.

Finally, in the case of a credit event, Eurex Clearing will execute cash settlements in accordance with ISDA-approved protocols subject to ISDA providing access to the results of credit event auctions, which is critical for effective risk management in CDS products and ensure market integrity.

## 5. *Suggestions for future regulatory proposals*

The Commodity Futures Modernization Act of 2000 (“CFMA”) provides a successful template for any future regulatory enhancements to address the concerns raised during the hearings before this Committee. For example, Section 112 of the CFMA added a new provision establishing the regulatory oversight that would apply to a clearing house operating as a Multilateral Clearing Organization (“MCO”) with respect to OTC derivatives transactions. It authorizes: 1) banks; 2) clearing agencies registered under the Securities Exchange Act of 1934; 3) DCOs registered under the Commodity Exchange Act; and 4) clearing organizations supervised by a foreign financial regulator that a U.S. financial regulator has determined satisfies appropriate standards, to operate as an MCO.

The market in OTC CDS transactions is global in scope, with roughly half of all traded volumes deriving from Europe. Eurex Clearing believes that any regulatory proposal must be measured against the effect that it might have on the global nature of the market and should take into account the following factors:

- Does the regulatory proposal recognize, and is it premised on, cross border regulatory cooperation to avoid “regulatory arbitrage”?
- Does it take into account global regulatory standards and business practices?
- Does it provide an appropriate level of flexibility in implementation?
- Does it erect artificial legal barriers or does it encourage competition?

Section 112 of the CFMA is quite forward thinking in that it recognizes that in a global market, clearing organizations regulated by a foreign regulator satisfying appropriate standards should be able to be authorized to clear OTC derivative transactions for U.S. persons and in the U.S. In fact, using that authority and measuring the foreign regulatory framework against the Core Principles for DCOs of the Commodity Exchange Act, the CFTC has recognized several foreign regulatory authorities as meeting appropriate standards in connection with the foreign regulator’s oversight of particular CCPs.<sup>8</sup>

The Core Principles for U.S. DCOs found in section 5b of the Commodity Exchange Act lend themselves to comparison to the regulatory regimes that apply in other national jurisdictions in a way that prescriptive regulatory provisions can not. By way of example, the Core Principles for DCOs are broadly consistent with the recommendations for CCPs of the International Organization of Securities Commissions and the Bank for International

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<sup>8</sup> Most recently, the CFTC recognized the U.K. FSA in connection with its oversight of ICE Clear Europe, See <http://services.cftc.gov/SIRT/SIRT.aspx?Topic=ClearingOrganizations&implicit=true&type=MCO&CustomColumnDisplay=TTTTTTTT>

Settlements.<sup>9</sup> Moreover, many of the broad requirements in the Banking Act parallel Core Principles which apply to U.S. DCOs.

Of course, coupled with broad international acceptance of appropriate regulatory standards must be robust arrangements for cooperation by international regulatory authorities and a ready framework for information sharing.<sup>10</sup> The current framework, incorporated in Section 112 of the CFMA is based upon broadly accepted regulatory standards and permits reliance by U.S. regulatory authorities on those standards being enforced by the regulatory authority of the CCP's home jurisdiction. It provides a sound regulatory foundation for clearing of OTC CDS transactions in a global market.

Eurex Clearing strongly believes that there are unmistakable benefits, even for U.S. market participants, to having a European clearing solution serving the global market, as currently being implemented by Eurex Clearing for the CDS market. A large percentage of international trading is priced in Euro and access to a European CCP facilitates these transactions. In this respect, many U.S. market participants seek to diversify their portfolios through exposure to European-based securities and trade CDS related to them. Moreover, a large percentage - perhaps a third - of the global trading in CDS focuses on the credit of sovereign European governments and European businesses the economics of which are driven primarily by local, contemporaneous European market developments. For example, corporate actions which may directly affect the values of such CDS occur, by and large, during the European business day. Furthermore, because the determination of credit events underlying CDS, particularly those referring to the restructuring, is subject to practices specific to the jurisdiction of the reference entity, ISDA's European offices would likely make determinations about what constitutes a credit event for a CDS with a European reference entity.

Moreover, Eurex Clearing believes that financial surveillance as well as market surveillance is crucial to the clearinghouse's proper supervision and that these functions are enhanced by knowledgeable experts who have access to up-to-date information and are operating in real time along with the reference markets, thereby providing enhanced protection for all market participants. For these reasons, global participants in the European CDS market, which includes a sizable number of U.S. participants, will benefit from access to a European OTC CCP.

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<sup>9</sup> Compare section 5b of the Commodity Exchange Act, 7 U.S.C. §7b and "Recommendations for Central Counterparties," Report of the Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions, ("CCP Report") <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD176.pdf>.

<sup>10</sup> In addition to the broad acceptance by international regulators of the IOSCO recommendations in the CCP Report, many regulatory authorities, including the U.S. CFTC, U.S. SEC and BaFin are signatories to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange Of Information.

In addition, CCPs that serve global markets, if permitted under this framework to operate in the U.S. as MCOs, stand to offer U.S. markets the benefits of increased competition. This has the potential to offer U.S. market participants with alternative methods of doing business and access to clearing services for innovative products that may not otherwise be available. In this regard, as noted above, Eurex was the first exchange to list credit futures contracts when it listed futures on Euro-denominated iTraxx CDS indexes.

Accordingly, if Congress determines to enact regulatory enhancements, it should consider clarifying any perceived legal uncertainty with respect to the operation of the legal framework and whether other legal requirements apply to certain CDS transactions and not others. Such clarity would facilitate both domestic and non-U.S. CCPs with understanding and complying with the legal requirements.

## 6. *Conclusion*

Eurex Clearing supports fully appropriate regulatory oversight of listed and OTC derivatives. Eurex Clearing understands the importance of public confidence in these markets and is committed to the utmost level of cooperation with the regulatory authorities of those nations that have an interest in our clearing operations. In this regard, we appreciate the opportunity to work with the U.S. regulatory authorities with respect to our plans to offer central clearing services for CDS transactions. Eurex Clearing would note that the U.S. financial market regulators have been inclusive, cooperative and open.

Eurex Clearing also believes that the existing treatment of CCPs that are subject to oversight by a non-U.S. regulatory authority that satisfies appropriate regulatory standards is the right framework and we urge Congress to maintain and extend that approach in any future regulatory proposal, particularly proposals to address any perceived legal uncertainty with respect to the law which may apply to clearing of CDS transactions.

Finally, Eurex Clearing is honored to have been invited to present its views to this Committee and appreciates the opportunity to discuss these critically important issues. I am happy to answer your questions.