CME Group

<u>Via E-Mail (BaselCommittee@bis.org)</u>

February 4, 2011
The Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: <u>Consultative Document: *Capitalisation of bank exposures to central counterparties*</u>

Dear Committee Members:

CME Group Inc. ("CME Group"), on behalf of Chicago Mercantile Exchange Inc.'s clearing house division and CME Clearing Europe Ltd. (collectively, the "CME Group CCPs"), would like to express our appreciation to the Basel Committee on Banking Supervision ("Committee") for the opportunity to comment upon its Consultative Document issued on December 20, 2010 - *Capitalisation of bank exposures to central counterparties* ("Consultative Document"). In our view, it is particularly important that the CME Group CCPs and other central counterparties ("CCPs") provide meaningful input to the Committee at a time when crucial decisions on the future of financial regulation are being made. Bank capitalization requirements are a critical element of the overall financial regulatory system. Consequently, decisions of the Committee concerning the capitalization regime will have a material impact on other regulatory regimes and non-bank participants in the financial services industry. We strongly encourage the Committee to continue to involve industry participants and other regulatory bodies in its process.

CME Group's comments in this letter focus broadly on the process and the timeline outlined in the Consultative Document, and we provide our views on certain questions on which the Committee has specifically sought comments and additional questions that are raised by the Consultative Document. We are supportive of the Committee's desire to develop standards that will assure greater transparency, safety and efficiency in global financial markets - goals to which we remain steadfastly committed – and to encourage greater use of CCPs by banks for the clearing of financial transactions. We agree that, as reforms are implemented in the financial services industry that encourage and, in some cases, require the use of CCPs for clearing certain instruments, it is appropriate to evaluate whether changes are necessary to the current bank capitalization regime with respect to exposures to CCPs. In that process, we strongly recommend that the Committee carefully weigh industry comments and the results of the proposed Quantitative Impact Study ("QIS").

As the Committee notes in the Consultative Document, there are a number of standard-setting bodies which have an interest in, and clear responsibility for, addressing the public policy issues associated with the use of CCPs, and decisions by any one of these bodies, individually or collectively, could have spill-over consequences that could undermine the Committee's efforts as conveyed in this proposal. We are particularly concerned that the dates outlined in the proposal will not allow sufficient time for the Committee to secure comment from, and coordinate with, other regulatory bodies or to evaluate sufficiently industry comments and the results of the QIS. Moreover, those comments and the results of the QIS may well be incomplete or inaccurate in their conclusions because the regulatory reforms being implemented pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in the United States and the European Market Infrastructure Regulations ("EMIR") in Europe are not yet complete, thereby creating substantial uncertainty.

We urge the Committee to consider expanding its consultative process and extending the timeline for implementation in order to ensure that the resulting changes to bank capitalization requirements do not create unintended negative consequences that encourage regulatory arbitrage or undermine the goals of financial regulation reform --- not least because the capital charges for banks will affect not only banks but also non-bank participants in the financial system, including other regulated and unregulated entities that deal in swaps.

I. CME Group and the CME Group CCPs

CME Group's subsidiary, Chicago Mercantile Exchange Inc., operates the clearing house division of CME ("CME Clearing") for which it is registered with the CFTC as a derivatives clearing organization ("DCO"). In December 2010, CME Clearing Europe, Ltd. ("CMECE"), a wholly-owned subsidiary of CME Group, received the approval of the United Kingdom's Financial Services Authority ("FSA") to operate as a Recognized Clearing House. CME Clearing provides clearing of exchange-traded futures, options on futures, various over-the-counter derivatives and other products. CME Clearing has never defaulted on an obligation to its clearing members, nor has a clearing member of CME Clearing ever defaulted on its obligations to the clearinghouse. This is reflective of, and due to, the financial strength, safeguards and quality of risk management of CME Clearing.[1]

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[1] Our financial safeguards package includes each clearing member's collateral on deposit to support its positions, the collateral of the clearing member's customers to support their positions and a set of pre-funded and unfunded commitments that backs CME Clearing's performance of its obligations to non-defaulting clearing members. As of September 30, 2010, excluding collateral supporting open positions of approximately 85 billion dollars (US), the financial safeguards package is approximately 8 billion dollars (US), comprised chiefly of the following elements:

- Surplus funds of the exchange of 100 million dollars (US) for the primary clearing fund, and a CME corporate contribution of 100 million dollars (US) for interest rate swaps clearing
- Guaranty fund deposits from clearing members of approximately 2.2 billion dollars (US)
- Assessment powers of approximately 6.1 billion dollars (US)

CME Group has been an active participant in the financial regulatory reform process. With respect to the Basel Committee's issuances, we submitted a detailed comment letter to the Committee on April 16, 2010, in connection with its December 17, 2009 document on *Strengthening the resilience of the banking sector,*[2] with specific reference to those paragraphs relating to CCPs.

II. <u>Comments on Proposed Reforms</u>

The following comments from CME Group focus on a few key aspects of the Consultative Document:

- First, we agree with the proposal's goal of identifying a category of robust and appropriately-regulated CCPs as to which banks' exposures would be treated differently from bilateral exposures. However, we have questions and concerns about the designation and obligations of "Qualifying CCPs" ("QCCPs") under the proposal, and by whom bank exposures to QCCPs would be calculated.

- Second, we support the Committee's proposal concerning the 2 percent risk-weighting for bank exposures to QCCPs with respect to cleared OTC products, while recommending that the Committee continue the exclusion from counterparty credit risk capital charges for exchange-traded products.

- Third, we raise several significant concerns about the proposed approach with respect to capital charges for banks' exposures to QCCP default funds.

(a) Qualifying CCPs

We agree with the Committee's view that trading exposures to QCCPs should have a low risk weight. QCCPs must comply with the standards for CCPs which are issued by the Committee on Payment and Settlement Systems ("CPSS") and the International Organization of Securities Commissions ("IOSCO")(collectively, "CPSS-IOSCO"). (We understand that CPSS-IOSCO are currently in the process of strengthening those standards and expect to issue revised standards later this year.) Counterparty credit exposures to CCPs that do not meet these high standards would be treated as bilaterally-cleared exposures under the Committee's proposal. The Committee suggests that the home country functional

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We note, in particular, that, in September 2008, this regime withstood the demise of former CME Group clearing member, Lehman Brothers Inc. ("LBI"). Working in conjunction with the CFTC, CME Clearing helped protect the positions and collateral of LBI's customers and transfer them to other clearing firms. CME Clearing also worked to transfer and liquidate (where possible) LBI's sizeable "house" or proprietary portfolio, while preserving the continuity of our cleared markets and avoiding losses to futures customers or to our financial safeguards package. This result was due in large part to CME Clearing's risk-management experience and ability to appropriately margin the positions of LBI and its customers, even in times of extreme stress and volatility in the derivatives markets.

[2] Letter from CME Group (Kim Taylor, President, CME Clearing House Division, and Andrew Lamb, Chief Executive Officer, CME Clearing Europe, Ltd.) to The Secretariat of the Basel Committee on Banking Supervision re: Consultative Document: *Strengthening the resilience of the banking sector* (Apr 16, 2010).

regulator, and potentially various banking regulators, will determine whether a CCP is compliant with CPSS-IOSCO standards.

CME Group supports the Committee's efforts to provide greater incentives for banks to use QCCPs, consistent with CPSS-IOSCO standards, and we appreciate the Committee's acknowledgment that changes to the current approach will affect not only the regulated bank entities but also the CCPs, which we believe could potentially interfere with direct regulation of CCPs. Accordingly, we urge the Committee to continue to coordinate closely with CPSS-IOSCO and also to actively include the primary CCP regulators in its consultative process.

Substantively, we agree that an effective approach to the treatment of bank exposures to CCPs must first identify the risk management and operational requirements for CCPs that would make exposures to such CCPs eligible for lower capital charges. CME Group agrees that compliance with CPSS-IOSCO standards is an appropriate approach to such qualification. We read the proposal as establishing a general requirement that, to qualify as a QCCP, a CCP must both be compliant with the standards and subject to prudential oversight in a jurisdiction where a supervisor substantially enforces those principles as part of its regulatory oversight**.** We believe that QCCP status should be determined by a CCP's applicable home country functional regulator, with appropriate coordination with such country's primary banking regulators.

We look forward to the development of further information as to how this qualification process will be implemented and strongly recommend that the Committee coordinate its approach with the major CCP regulators to ensure that the qualification process is efficient, transparent and consistent globally and does not lend itself to regulatory arbitrage. This process should not unduly constrain the ability of a CCP's home country functional regulator to adopt and enforce standards or principles that may differ in their details where the differences are appropriate based on the home country regulatory regime and do not materially and negatively alter the risk profile or financial strength of the CCP. We think that a mechanism should exist to ensure that the qualification process is consistent not only in form but also in application and enforcement across countries. This qualification process should be part of a periodic review by which the home country functional supervisor confirms a CCP's ongoing qualification as a QCCP according to the latest CPSS-IOSCO standards. The initial qualification and ongoing review process should be transparent and consistent, and the results of the home country functional supervisor's determination should be made public.

(b) Trade Exposures

The Committee proposes that, rather than a zero capital charge, a small positive capital charge (based on a 2 percent risk weight) should be associated with posted collateral, mark-to-market exposures and potential future exposures (collectively "trade exposures") to QCCPs.

In our comment letter to the Committee of April 16, 2010, we stated our initial view that zero percent risk-weighting is appropriate for transactions cleared by a QCCP, irrespective of the regulators' desire to hold CCPs to more rigorous standards in the future. We noted that "not only does the use of QCCPs in clearing OTC derivatives transactions allow banking institutions to better assess and manage

counterparty risk arising out of individually negotiated OTC derivatives transactions, but the zero percent risk weighting also serves as an incentive for derivatives traders and market makers to use the CCPs across market segments and asset classes for clearable transactions." We recommend that the Committee continue to exclude trade exposures for exchange-traded derivatives that are cleared by QCCPs. We believe that the liquidity and transparency of such markets, coupled with the expert risk management and safeguards offered by QCCPs, and the success with which CCPs have managed portfolios of exchange-traded derivatives in actual default situations, favor continuation of this approach. Moreover, the continued exclusion of exchange-traded derivatives from the capital calculation will establish a modest incentive for supervised banks to utilize such products where appropriate based on their needs.

With respect to OTC derivatives that are cleared by QCCPs, we agree with the Committee's logic of establishing a small risk-sensitive capital charge, such as the Committee's proposed charge based on a 2 percent risk weight, for banks' trade exposures to QCCPs, which historically have given rise to very little risk exposure. While the proposed charge is not the zero percent risk-weighting that the Committee had referenced in the December 17, 2009 document (and that we had supported in our April 2010 comment letter), its low level still creates an incentive for banks to use the services of QCCPs for clearing OTC derivatives transactions that are deemed clearable according to well-defined criteria. As we had observed in the earlier comment letter, CME Group is supportive of capital requirements that are proportionate to the risk that market participants assume, and we therefore agree that bilaterally executed and settled transactions, due to their higher risk, should be subject to higher capital requirements than those cleared by a QCCP.

(c) Qualifying Default Fund Exposures

The Committee recommends that a bank should capitalize its default fund exposure to a QCCP according to a risk-sensitive approach that is based on the calculation of the QCCP's "hypothetical capital." Hypothetical capital would be calculated using a set formula with CCP-specific information.

CME Group supports the notion of pursuing a transparent and reasonably simple process for determining the appropriate risk-based capital ("RBC") charge for default fund exposures, but has concerns about the specific approach proposed. Importantly, the proposed approach seems to discount a QCCP's credit risk management practices and the credit quality of a QCCP's membership. Any approach that is adopted should be suitably robust and contain mechanisms that allow for changing market conditions – such as changes in the credit quality of a QCCP's clearing members, and thus contribute to systemic stability, particularly through the credit cycle. Also, the proposed approach assigns no significance to unfunded commitments of the clearing members.

CME Group notes that the Basel II CEM methodology is relatively simplistic and less responsive to diverse data points and new developments than the margin calculations typically deployed by today's CCPs that employ experienced risk managers to continually evaluate and actively update their models and risk management systems. In our view, these more granular and sophisticated margin calculations employed by CCPs should not be judged against standards that may not reflect risk as accurately as the

CCPs' models. The proposed measure could result in over-assessing or under-assessing the true capital requirements, although not in a predictable or risk consistent manner, and could prove disadvantageous to the financial system either way. Market participants might be dissuaded from utilizing a CCP's clearing services if capital requirements are set at a level that is unnecessarily high. The question arises: What are the potential consequences of a situation where the relevant supervisors of a CCP state that the entity has met its necessary capital requirements, but the Basel calculation for "hypothetical capital" shows a shortfall? From a public perspective, such a scenario could give rise to unnecessary loss of confidence in a CCP and would be at odds with the very purpose of encouraging central clearing and promoting greater stability in the financial system. It could equally be interpreted as a failure of necessary regulatory coordination.

We also note that, even if we were comfortable with the hypothetical capital approach as outlined in the Consultative Document, we would be concerned that the calculation would be difficult. We believe that QCCPs are best equipped to compile and manage the necessary information to determine the counterparty credit risk exposures of their clearing members. It would be neither efficient nor practical for banks to assess credit quality of other clearing members and determine default fund exposures based on information disseminated by the CCPs. Also, verification of results and quality control under the proposed approach could prove to be burdensome for regulators, banks and CCPs alike. If, however, the calculation were performed at the CCP level, the results could more easily be verified by the home regulator.

The likelihood that a CCP will find it necessary to use default fund deposits posted with a CCP to cover a default by a clearing member depends upon the CCP's financial strength, including its own or committed parental resources and its risk management practices. Although we recognize that certain differences exist between the nature of transactions cleared by a CCP and the deposits posted with it, we believe that default funds deposited with QCCPs that meet the standards established by CPSS-IOSCO should also be entitled to a simple and low risk weight.

CME Group believes that the Committee should take as much time as is necessary to consider alternative approaches to the proposed methodology and, as a QCCP, we would be willing to participate in a concerted and broad-based effort to develop a more suitable approach --- one that would avoid the unintended consequences of using a potentially inaccurate measurement of capital requirements.

III. Comments on process and timelines

CME Group supports the work of the Committee and other standard-setting bodies, and we are prepared to assist supervisors and regulators as they move forward with the development of a globally consistent, highly transparent process to identify and control risk as it relates to CCPs. This proposal for determining the capital requirement for bank CCP members and bank customers clearing through CCP members is an excellent first-step. We encourage the Committee to continue engaging in an active dialogue with other relevant standard-setters and industry participants to ensure that the full spectrum of RBC charges assigned to financial instruments remains appropriately risk-sensitive and consistent

with public policy goals. Capital standards must not reduce efficiencies in the market place or impose unnecessary costs on clearing firms and CCPs without commensurate risk management benefits.

We strongly urge the Committee to consider adjusting the proposed timeline to ensure that the intended objectives are met and that unintended consequences are avoided. With the continued fragile state of global financial markets and the early signs of a stronger global financial system and economy in view, it would be counterproductive to expedite finalization of a change to the RBC regime for bank members of CCPs without a better understanding of the direction of the other moving parts. We recommend, in particular, that the Committee consider extending the roll-out of the QIS and also consider aligning its timeframes more closely to those of the CPSS-IOSCO and the national jurisdictions.

There are many variables at this time, and it may be too early or premature to establish a methodology when major jurisdictions, such as the U.S. or the EU, have not yet finalized their effort at regulatory reform of the derivatives and capital markets. While the Committee has acknowledged its intention to finalize the proposed rules once the revised CPSS-IOSCO standards are published later this year, it may wish to consider waiting to proceed further on this initiative until the CPSS-IOSCO have released their consultative document in March and have had the opportunity to take into account industry and regulatory commentary. We understand the Committee's desire to work towards implementing all counterparty credit risk ("CCR") reforms, including the CCP-related ones, by January 2013, but we believe that additional time in the short-term is warranted and would help both to ensure the integrity of the process and lead to the best final result for all parties. A prudent delay would also help ensure that the QIS process is rendered more meaningful and robust by allowing firms adequate time to gather their data and complete their preparatory analyses.

Finally, in this regard, we want to emphasize the importance of getting the CCP capital charge framework developed as a sound RBC framework in and of itself and also relative to other products. There are many changes underway to RBC requirements, as well as standards and expectations, and often the interplay between these various frameworks is what drives overall behavior in financial systems and markets.

IV. Conclusion

In conclusion, CME Group reiterates our support of the Committee's efforts to provide greater incentives for banks to use QCCPs, consistent with CPSS-IOSCO standards, and the need for careful consideration of the potential consequences of the proposed changes to the RBC framework.

CME Group agrees that the estimation of the appropriate capital charge against the default fund is important and challenging. While we understand the need for simplicity and transparency in this calculation, we are of the view that the approach should be designed in a way that avoids creating disincentives for clearing members to use QCCPs. We do not believe that enough is known about the proposed approach at this time to conclude that that is the case. We urge a very deliberate approach to determining the appropriate approach to that determination, and would be willing to work with the Committee and other industry and regulatory representatives to develop such an approach.

CME Group would like to thank the Committee for the opportunity to provide these comments. If you have any comments or questions, please feel free to contact Kim Taylor, President, CME Clearing, at (312) 930-3156 or Kim.Taylor@cmegroup.com; Andrew Lamb, Chief Executive Officer, CME Clearing Europe, Ltd., at (44) 207-796-7170 or Andrew.Lamb@cmegroup.com; or Ann Shuman, Managing Director and Deputy General Counsel, at (312) 648-3851 or Ann.Shuman@cmegroup.com.

Very truly yours,

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