CME Group

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

November 25, 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 ("CME Clearing"), would like to express our appreciation to the Basel Committee on Banking Supervision ("Committee") for the opportunity to comment upon its second Consultative Document issued on November 2, 2011 - *Capitalisation of bank exposures to central counterparties* ("Consultative Document"). In our view, it is particularly important that CME Group 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 has actively participated in the consultative process. In February this year, CME Group submitted a comment letter on the first Consultative Document in which we expressed our support for the Committee's desire to develop standards that will assure greater transparency, safety and efficiency in global financial markets and to encourage greater use of CCPs by banks for the clearing of financial transactions. In the letter we also raised various concerns over the proposed bank capitalization regime with focus on the proposed methodology to capitalize bank exposures to CCPs.[1] The Committee will recognize that many items of concern raised in our last letter have been reiterated within this letter. CME Group, along with other CCPs and market participants, discussed many of these concerns with the Risk Management and Modelling Group ("RMMG") during the workshop on April 13, 2011 in London. CME Group has also participated in each of the RMMG's quantitative impact studies ("QIS"). It is our view that these quantitative impact assessments have provided, and will continue to provide, critical perspective at a time when extensive bank capitalization revisions are being made.

[1] Previous CME Group comment letter in February 2011 (*Re: Consultative Document: Capitalisation of bank exposures to central counterparties, 4 February 2011)*

We observe several welcome changes in the revised Consultative Document that are reflective of comments provided by CME Group as well as the broader industry. However, we remain concerned that the proposal may discourage migration towards central clearing, in direct contrast to the objectives stated by the G20, provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and the E.U.'s regulation on OTC derivatives, central counterparties and trade repositories ("EMIR").

More specifically, we continue to have significant reservations regarding the usage of the Current Exposure Method ("CEM") to quantify capital requirements related to default fund exposures. As these capital requirements are slated to become one of the larger components of the new capital framework, a comprehensive evaluation of CEM's ability to appropriately capture and quantify such exposures is critical. The CEM methodology, originally designed to measure bilateral risk, is relatively simplistic and less responsive to the diverse and rapidly evolving profile of transactions brought to clearing. Adopting the CEM methodology fails to recognize existing time-tested and risk sensitive methodologies of capturing and quantifying risk exposure employed by many CCPs. Analysis of our previous and scenario-based QIS results have further validated CEM's inability to adapt to a dynamic composition of portfolios, leading to an overstatement of default fund exposure risks and an understatement of CCP risk mitigation capabilities.

Below are CME Group's comments on the Consultative Document.

I. Comments on Revised Proposals

1) Indirect Access to CCPs

Basel Text: Revised segregation and continuity requirements so clients of clearing members can benefit from the CCP framework where a client's trade with a clearing member is effectively a trade with the CCP.

CME Group Comment: We believe it is entirely appropriate to recognize the client (customer of a clearing member) protection scheme offered by an agency model. In the event of a clearing member ("CM") default, the structure of the relationship between the CM and its clients facilitates various operational efficiencies including, but not limited to, the portability of client positions and collateral. This agency relationship is fundamental to the operation of CME Clearing and is imbued throughout the rules of CME Group and the Commodity Exchange Act as well as the regulations of the U.S. Commodity Futures Trading Commission ("CFTC").

Basel Text: The client must be in a position to provide to the national supervisor, if requested, an independent, written and reasoned legal opinion that concludes that, in the event of legal challenge, the relevant courts and administrative authorities would find that the client would bear no losses on account of the insolvency of an intermediary clearing member or of any other clients of such intermediary under relevant law:

CME Group Comment: We believe the requirement is unnecessarily broad and vague. First, a legal opinion should not be required unless there is a reasonable basis for concern that the applicable laws and regulations do not provide for the desired outcome. Second, if a legal opinion is required, it is unreasonable to demand that each client provide a separate opinion. A single opinion in favor of a clearing house in the jurisdiction should be satisfactory.

The requirement that: "the client would bear no losses on account of the insolvency of an intermediary clearing member or of any other clients of such intermediary under relevant law," should be clarified. Is it intended that the client must be protected against theft of its funds by the intermediary or a third party? Must the client be protected against fellow customer risk? Must the protection be instantaneous, such that an insolvency does not impair the ability to transfer all open positions and account value? If the proposal encompasses all of those elements, it is questionable whether any jurisdiction can ever meet those requirements. Therefore, we encourage the Committee to adopt language that acknowledges that the legal system in certain jurisdictions satisfies the Committee's objectives and to frame its objectives in terms of reasonable assurance rather than absolutes.

Basel Text: Relevant laws, regulation, rules, contractual, or administrative arrangements provide that the offsetting transactions with the defaulted or insolvent clearing member are highly likely to continue to be indirectly transacted through the CCP, or by the CCP, should the clearing member default or become insolvent. In such circumstances, the client positions and collateral with the CCP will be transferred at market value unless the client requests to close out the position at market value.

CME Group Comment: The revised language surrounding portability better recognizes the CCP’s ability to confidently facilitate the transfer of client positions and collateral in the event of CM default subject to its existing laws, regulation, rules, contractual, or administrative arrangements.

Basel Text: The revised approach also introduces a new risk weighting category of 4% for the occasion when a client is not protected from loss in the case of joint default of both the clearing member and other clients, but meets all other requirements for segregation and continuity of accounts. A risk weight of 4% is proposed for trade exposures in such cases.

CME Group Comment: We would like the Committee to further elaborate on the basis of this additional category including any data analysis that would provide further perspective for the 4% risk weight.

2) CVA Charges

Basel Text: The clearing member will always capitalise its exposure (including potential CVA risk exposure) to clients as bilateral trades, irrespective of whether the clearing member guarantees the trade or acts as an intermediary between the client and the CCP.

CME Group Comment: We support the proposition that CMs are not required to hold capital for CVA risk for centrally cleared derivatives. We believe this capital relief is a necessary incentive for central clearing. But the rule text is unclear regarding client cleared transactions. It appears that the CM will need to incur a bilateral CVA charge on client cleared transactions regardless. This rule conflicts with footnote 6 in Section III (a) of the Consultative Document and we would like the Committee to clarify how these charges should be applied to client cleared trades. We believe counterparty credit risk exposure of client cleared trades should be much lower than a bilateral exposure regime due to a CCP's risk management practices and capabilities. Care should also be taken to assure that risk management standards do not inappropriately rely on methods to enhance pro cyclicality.

3) Trade Exposures

Basel Text: The capital charge reflects the risk of default of the QCCP, which is assumed to be very low. As such, this exposure receives a very low risk-weight of 2%.

CME Group Comment: We agree with this risk weight being applied to cleared OTC derivatives transactions. However, we continue to recommend that the Committee exclude trade exposures for exchange-traded derivatives ("ETD") that are cleared by QCCPs. As stated in our previous letter, we believe that the liquidity and transparency of such markets, coupled with the recognized risk management and safeguards offered by QCCPs, and the success with which CCPs have managed portfolios of ETDs in actual default situations, favor continuation of this approach.[2] Moreover, the continued exclusion of ETDs from the capital calculation will establish a modest incentive for banks to move OTC derivatives onto supervised exchanges or swap execution facilities.

4) Default Fund Risk Weighting

Basel Text: Where a substantial excess amount of DFcm exists over the hypothetical capital requirement, the 1.6% capital requirement is reduced, subject to a floor of 0.16%, on a sliding scale by applying a "decay factor" to reflect the diminishing risk associated with large amounts of DFcm.

CME Group Comment: We believe the range of risk weights assigned to default fund is unreasonably wide and may pressure a shift in the balance between initial margin ("IM") and default funds chosen by a CCP. It is our view that a CCP should reasonably pursue a "defaulter pays" approach which emphasizes reasonably conservative margin coverage. The default fund performs as the CCPs capital reserve and provides mutual incentives through risk mutualization. Risk mutualization is the ultimate cornerstone of a CCP's risk management framework and is key feature of risk awareness and vigilance in a central clearing framework. Risk mutalization promotes risk monitoring among CMs and provides strong incentives for them to actively participate in the risk management activities of the CCP. The current formula may alter the CCP's risk-based balance between IM and default funds.

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[2] Previous CME Group comment letter in February 2011 (*Re: Consultative Document: Capitalisation of bank exposures to central counterparties, 4 February 2011)*

We support the revision of the capital floor to a sliding scale ranging from 0.16% to 1.6%. However, we believe the upper limit risk weight of 1250% is excessively punitive; such risk weight is only applied to the highest risk exposures under the current Basel risk-based capital framework. For example, equity exposures are risk weighted at less than 400%. As mentioned above, the probability of using and completely exhausting a default fund is exceptionally remote. In fact, CCPs such as CME Group use their own capital ahead of default fund contributions from CMs in their default resource 'waterfall'. This structure provides CCPs with strong incentives to prudently manage and collateralize counterparty exposures. We are concerned that the risk weight prescribed by the Committee overstates the risk associated with default funds and would create a major roadblock for moving bilateral transactions towards central clearing. We recommend lowering the upper limit to a level that is, at a maximum, comparable to that applied to equity exposures.

5) Hypothetical Capital (Kccp) Calculation

Basel Text: To address the concern that the CEM underestimates the multilateral netting benefits arising from a CCP, the factor in the CEM which controls the amount of netting (rho) is increased from 0.6 to 0.7. Analysis of netting benefits for large and roughly balanced portfolios, which should be the case for CCPs, indicates that a rho of 0.7 more closely reflects the actual netting benefits.

CME Group Comment: CME believes the revised formula of Anet still does approach the actual netting benefits provided by a CCP. An observed flaw is that CEM quantifies exposure based on a constant percentage of notional without recognizing risk mitigation via netting nor any client or CM portfolio diversification. The multilateral netting capabilities provided by a CCP are markedly more efficient than bilateral netting for which CEM was designed. Detailed review of our QIS results has evidenced that aggregate capital requirements rely disproportionally on the gross notional of positions and lacks consideration for more risk-based metrics CCPs currently have available to measure exposures.

Basel Text: The rules require that CCPs use the Current Exposure Method (CEM) to perform this calculation, as this is the only simple approach that will ensure consistent and verifiable implementation. Since this calculation is performed from the QCCP perspective, the collateral posted to the CCP (initial or variation margin) as wells as the default fund contribution from each member are treated as risk mitigants which reduce the exposure that the CCP has to each CM.

CME Group Comment: CME Group agrees with the inclusion of default funds in computing a CMs exposure at default provided the CCP utilizes a defaulting CMs default funds ahead of any mutualization.

Scenario based analysis demonstrates that under CEM, Kccp's sensitivity to IM and default fund decreases drastically as gross notional increases. These results are unsurprising as CCP margins and default funds are not calculated based solely on the notional amount of the positions. Conversely, CCP risk models consider, among many things, portfolio hedging and diversity, recognizing that the relationship between gross notional and risk is not always linear. The risk insensitivity of CEM creates a variety of perverse incentives for CMs to reduce both default fund contributions and

margins or increase margins at the expense of reduced default fund contributions, actions that, in our view, lead to increased systemic risk.

CME Group believes there are many risk-based alternatives to CEM available that could be readily computed by CCPs. An alternative method that incorporates daily margin-based information, data readily available by all CCPs, would better evaluate risk sensitivities of positions carried by CCPs. With access to real time market data, CCPs could perform EBRM calculations on a daily basis to more accurately determine residual risk. To be conservative, for example, CCPs could stress current margin models with a higher confidence interval (e.g. from 99% to, or even above, 100%) to calculate EBRM.

We are also aware of alternatives suggested by the industry and we encourage the Committee to continue evaluating these alternatives before final rule making. Additionally, we are willing to work with the Committee to evaluate, develop, and support any potential alternative methods.

Basel Text: The CEM exposure at default (EAD) for options contracts will be calculated by multiplying the contract notional by its "delta", to reflect the "moneyness" of the option.

CME Group Comment: CME Group agrees with this approach.

6) Allocation of Kcm

Basel Text: The aggregate capital requirements calculated in Step 2 need to be allocated to the individual clearing members. This allocation is based on the proportion of each clearing members' default fund contribution to total default funds. The allocation factor also takes into account the granularity and concentration of the CCP. The more granular and the less concentrated is a CCP, the less punitive is the allocation factor.

CME Group Comment: Although allocating capital requirements based on pro-rata share of the default fund appears sensible, it is important to consider the varying methodologies CCPs use to size and allocate default funds. For example, a CCP may size the aggregate default fund to cover one or two largest defaults, a figure that may vary in its determination across CCPs, and allocate based on volumes, margin requirements, products, potential exposure or a combination thereof. Therefore, a pro-rata allocation of the aggregate default fund may be inappropriate for universal application.

Additionally, we are concerned over the appropriateness of the additional concentration and granularity adjustment ("allocation factor") and its inability to react to varying CCP structures, governing regulations, where applicable, and rules and operational practice. Although we agree, in concept, of the inclusion of such an adjustment, we have reservations of universal applicability of the formula. We encourage the Committee to consider that CCPs who adhere to the principles (*e.g.,* QCCP) of the Committee on Payment and Settlement Systems and the Technical Committee of the International Organizations of Securities Commissions ("CPSS-IOSCO") maintain numerous additional safeguards, in comparison to non-QCCPs, that mitigate the potential exposure the allocation factor seeks to capture.

Further, we believe the factor, based on the current formula, may lead to more excessive additional capital requirements than anticipated. We are of the view that there is not sufficient historical analysis or comparable data to assess the appropriateness of the current formula. We therefore encourage the Committee to assess how this formula reacts to current and future data (*e.g.* QIS results) to validate the appropriateness of the aggregate capital requirements.

7) Eligible Collateral and Haircuts

We request further discussion and consideration over collateral types and the appropriateness of prescribed collateral haircuts. The collateral types and haircuts applied to the computation of Basel III capital requirements originate from the Basel II Accord. It is our view that this static text is inappropriate and lacks consideration for the various collateral types, risk profiles, and risk-based haircuts as well as concentration limits applied by certain CCPs.

For example, CME Clearing practice is to provide consideration for any positive value generated from the change in value of option positions and apply it to margin requirements. Therefore, positive option value effectively operates as collateral. Additionally, the prescribed Basel II haircut for money market mutual funds ("MMMF") is currently 25%. The related Basel II text states that the applicable haircut for UCITS/Mutual Funds to be the highest haircut applicable to any security in which the fund can invest. In the United States, Rule 2a-7 of the Securities and Exchange Commission's ("SEC") Investment Company Act of 1940, establishes MMMF guidelines for quality, maturity, and diversity. CME Clearing practice is to accept only MMMFs that are compliant with Rule 2a-7, and therefore, based on the composition of the underlying securities, as restricted by Rule 2a-7 and interpretation of Basel II text, the appropriate haircut for CME Clearing MMMFs on deposit would range from 2-4%.

Therefore, we suggest applying the prescribed Basel II text as a baseline standard while recognizing the more dynamic collateral types and risk based haircuts applied by CCPs.

II. <u>Comments on process and timelines</u>

CME Group supports the work of the Committee and other standard-setting bodies, and we are prepared to assist supervisors as they move forward with the development of a globally consistent, highly transparent process to identify and control risk as it relates to CCPs. We encourage the Committee to continue engaging in an active dialogue with other relevant standard-setters and industry participants. Capital standards must not reduce efficiencies in the marketplace or impose unnecessary costs on CMs and CCPs without commensurate risk management benefits.

Moreover, comments received as well as current results of QIS may well be incomplete or inaccurate in their conclusions as various global regulatory reforms, including Dodd-Frank in the United States and EMIR in Europe, are yet to be finalized and thereby substantial uncertainty remains. In particular, results

of related data analysis for cleared OTC trades are only readily available for dealer's portfolios that may contain markedly different risk characteristics compared to client portfolios.

While the Committee has acknowledged its intention to finalize the proposed rules by the end of this year, it may wish to consider waiting to proceed further on this initiative until CPSS-IOSCO have released their final principles and have had the opportunity to take into account additional industry and regulatory commentary. A prudent delay would also help ensure that the QIS process is rendered more meaningful and robust by allowing CMs adequate time to gather data and complete their preparatory analyses.

III. Conclusion

CME Group reiterates our support of the Committee's effort 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 risk-based capital ("RBC") framework.

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 CMs to use QCCPs. The default fund exposure and CVA charges may dissuade some banks from becoming CMs, potentially resulting either in a concentration of clearing house exposures to a smaller group of banks or in the role of clearing member being undertaken by non-bank entities. We understand the Committee's desire to work towards implementing all counterparty credit risk reforms by January 2013, but we believe that additional time in the short-term would help both to ensure the integrity of the process and lead to the best final result for all parties. We look forward to the opportunity to work with the Committee and other industry and regulatory representatives to develop the most sensible approach.

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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