CME Group

Via E-Mail (BaselCommittee@bis.org)

Sept. 20th 2013

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

RE: BCBS 251 Consultative Document: *Revised Basel III leverage ratio framework and disclosure requirements.*

Dear Committee Members:

CME Group Inc. ("CME Group"), on behalf of Chicago Mercantile Exchange Inc.'s Clearing Division ("CME Clearing") and CME Clearing Europe Limited ("CME Clearing Europe"), would like to express our appreciation to the Basel Committee on Banking Supervision ("BCBS" or "Committee") for the opportunity to comment on this consultative document issued on June 28, 2013. CME Group is the parent of five designated contract markets ("DCMs"): CME, the Board of Trade of the City of Chicago, Inc. ("CBOT"), New York Mercantile Exchange, Inc. ("NYMEX"), the Board of Trade of Kansas City Missouri, Inc. ("KCBT") and Commodity Exchange, Inc. ("COMEX"). These DCMs collectively offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. CME's clearing house division ("CME Clearing") and CME Clearing Europe together offer clearing and settlement services for exchange-traded futures contracts, as well as over-the-counter ("OTC") derivatives transactions. CME is registered with the CFTC as a derivatives clearing organization ("DCO") and is one of the largest central counterparty ("CCP") clearing services in the world. CME Clearing Europe is regulated and supervised by the Bank of England as a recognized clearing house ("RCH") in the United Kingdom and is in the process of becoming reauthorized under the European Market Infrastructure Regulations ("EMIR").

CME Clearing and CME Clearing Europe are risk management organizations that independently assess risk management issues and neutrally establish risk management standards attendant to the risk management and intermediation services we provide. CME Group is particularly interested to assess and understand how the BCBS 251 consultative document, taken together with other BCBS consultative documents such as the BCBS 253 and 254 consultative documents, will incentivize the clearing of clearable OTC derivatives in accordance with G20 public policy objectives, and otherwise impact the cost and risk profile of exchange traded derivatives. CME Group is particularly sensitive to how BCBS consultative documents, if enacted into binding regulation in applicable jurisdictions, will impact or otherwise influence the margining, liquidity sourcing, and guaranty fund levels required for centrally cleared derivatives. As a reminder, CME has operated a central counterparty for over 100 years through a variety of market crisis events and CME default funds have never been drawn upon to cover the

default of a clearing member. Our initial studies of the BCBS 251, 253, and 254 consultations indicate that the standards proposed through these consultative documents are conflicting, can be seen to disincentivise clearing, and could encourage the use of uncleared markets, thus re-enforcing the problems seen in the 2008 crisis for OTC derivatives. This result would directly contradict the BCBS's stated policy goal of crafting standards that seek to incent clearing of standardized OTC derivatives. By way of example, the BCBS specifically states in BCBS 253 that one of its goals is to "support [for] the broader G20 mandate to promote central clearing of OTC derivatives as a way to reduce systemic risk…."[1] We believe the issues posed by these consultative documents can be broadly classed into two major areas of concern: gross overestimation of the capital required for CCP default funds, and punitive leverage ratio charges for cleared client collateral due to incorrect assumptions on the ability of banks to use cleared client collateral for leverage[2] and the guarantees provided by banks in the cleared market.

Focusing on this consultative document, CME Group fully supports the Committee's effort to limit the build-up of potentially destabilizing leverage in the banking sector and introduce a framework to ensure comparability of leverage profiles between banks. Our focus in this letter will be specific to issues we have identified in the BCBS 251 text and will include:

(I) General Comments

(II) Items for Clarification

(I) General Comments

Centrally Cleared Customer Exposures to Derivatives

The BCBS 251 text states in section 26 that the collateral received in connection with derivative contracts has two countervailing effects on leverage: it reduces counterparty exposure while increasing the economic resources at the disposal of the bank. This view is due to the mistaken assumption by the BCBS that banks can use cleared customer collateral to leverage themselves. While this assumption may have some merit in the uncleared markets and certainly was occurring in the prime brokerage area before the 2008 crisis, which may have contributed to the severity of the event, it is untrue for the regulated futures and cleared OTC markets in the United States and Europe.

Section 4d(a)(2) of the Commodity Exchange Act ("Act") requires each Futures Commission Merchant (FCM) to segregate from its own assets all money, securities and other property deposited by futures customers to margin, secure, or guarantee futures contracts and options on futures contracts traded on designated contract markets. Section 4d(a)(2) further requires an FCM to treat and deal with futures

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[1] Basel Comm. Banking Supervision, *Consultative Document: Capital Treatment of Bank Exposures to Central Counterparties* [hereafter BCBS 253] ¶ 14(ii) (June 2013).

[2] CFTC and ESMA regulations both prohibit this practice as explained in more detail below.

customer funds as belonging to the futures customer, and prohibits an FCM from using the funds deposited by a futures customer to margin or extend credit to any person other than the futures customer that deposited the funds. Section 4d(f) of the Act, which was added to address the cleared OTC markets by section 724(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires each FCM to segregate from its own assets all money, securities and other property deposited by Cleared Swaps Customers to margin transactions.

In 2012, the CFTC revised Regulations 1.20 through 1.30, and 1.32, to implement section 4d(a)(2) of the Act, and adopted Part 22 to implement section 4d(f) of the Act. The purpose of these regulations is to safeguard funds deposited by futures customers and Cleared Swaps Customers, respectively.

CFTC Regulation 1.20 requires each Futures Commission Merchant (FCM) and Derivatives Clearing Organization (DCO) to separately account for and to segregate from its own proprietary funds all money, securities, or other property deposited by futures customers for trading on designated contract markets. Regulation 1.20 also provides that an FCM or DCO may deposit futures customer funds only with a bank, trust company, and for FCMs only, a DCO or another FCM. The funds must be deposited under an account name that clearly identifies the funds as belonging to the futures customers of the FCM or DCO and further shows that the funds are segregated as required by section 4d(a)(2) of the Act and Commission regulations. FCMs and DCOs also are required to obtain a written acknowledgment from a depository stating that the depository was informed that funds deposited are customer funds being held in accordance with the Act. FCMs and DCOs also are restricted in their use of futures customer funds. Regulations 1.20 and 1.22 provide that the funds deposited by one futures customer may not be used to <u>margin or to secure the contracts or option positions, or extend credit to any person, other than the futures customer that deposited the funds in the normal course of business.</u>

Part 22 of the CFTC regulations, which governs Cleared Swaps transactions, implements section 4d(f) of the Act and parallels many of the provisions in Part1 addressing the manner in which, and the responsibilities imposed upon, an FCM holding funds for futures customers trading on designated contract markets. Regulation 22.2 requires an FCM to treat and to deal with funds deposited by Cleared Swaps Customers as belonging to such Cleared Swaps Customers and to hold such funds separately from the FCM's own funds. Regulation 22.4 provides that an FCM may deposit Cleared Swaps Customer Collateral with a bank, trust company, DCO, or another registered FCM. Regulation 22.6 requires that the account holding the Cleared Swaps Customers Collateral must clearly identify the account as an account for Cleared Swaps Customers of the FCM engaging in cleared swap transactions and that the funds maintained in the account are subject to the segregation provisions of section 4d(f) of the Act and Commission regulations. Regulation 22.2(d) also prohibits an FCM from using the funds deposited by one Cleared Swaps Customer <u>to purchase, margin, or settle cleared swap transactions of any person other the Cleared Swaps Customer that deposited the funds</u>.

The European Market Infrastructure Regulation (EMIR) Regulation (EU) No 648/2012, Art. 39 requires similar segregation, detailed Appendix I.

The aforementioned regulations clearly prevent banks from using cleared customer collateral to leverage themselves. BCBS 251 incorrectly makes the assumption that cleared customer collateral has the effect of both mitigating credit exposures and increasing the ability of banks to leverage. In actuality cleared customer collateral only mitigates credit exposures where such arrangement is subject to a segregation regime. In such cases, collateral received from customers in connection with centrally cleared derivative contracts should not be included in the leverage ratio.

Further, customer trade exposures to centrally cleared derivative contracts are collateralized as required by the CCP and the individual clearing member firm, and as such should be reflected in the leverage ratio based on the residual net exposure following the netting of the customer exposure and the collateral the customer has posted. As written today, the leverage ratio requires banks to measure both the collateral and exposure related to customer activity at their clearing member firms on a gross basis. We have outlined above how customer collateral for centrally cleared derivatives is required by the CFTC and EMIR to be held separately for customers in order to apply specifically to their derivatives trading activity with the clearing house. Since the customer collateral related to these exposures is set aside solely to cover potential exposures with those centrally cleared derivatives, the final leverage ratio requirement for these trade exposures should reflect the net exposure amount by allowing the customer collateral to reduce the trade exposure. This approach reflects the true exposures for the bank clearing member firms since the bank will have taken into account the customer exposure and the customer collateral received solely for that exposure that the bank cannot use for their own leverage purposes since the collateral is required to be segregated by the CFTC and EMIR. To the extent the bank exercises its right to invest customer segregated funds as permitted by the respective regulatory body, the investment vehicle must be held in the customer segregated account.

The leverage ratio should be revised to more accurately reflect the restrictions on the banks' ability to use customer collateral in a centrally cleared environment. These changes would have the doubly beneficial impact of accurately reflecting the realities of the centrally cleared futures and OTC markets and aligning banks capital costs for central clearing with the BCBS' stated goals in favor of central clearing for standardized OTC products.

Centrally Cleared Proprietary Exposures to Derivatives

The BCBS 251 text states in section 27 that collateral received in connection with derivative contracts does not reduce the economic leverage inherent in a bank's derivative position and does not permit collateral received by a CCP to be netted against derivatives exposures. To the extent the bank holds proprietary derivatives position, it is required to collateralize exposures with the CCP or an intervening FCM, which exerts a first priority security interest over the collateral, and otherwise establishing control of the collateral. Thus, the collateral may not be used by the bank to leverage itself.

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Since collateral offsets a portion of banks' proprietary trade exposures and may not be used elsewhere to increase leverage, the collateral posted to the CCP does in fact reduce the economic leverage inherent in a bank's derivative position. As such, bank collateral for proprietary cleared positions should be netted against derivatives trade exposures similar to the approach recommended above for customer cleared activity.

Similarly, the BCBS 251 text states in section 28 that banks must gross up their Exposure Measure by the amount of any derivatives collateral provided. To the extent the bank over-collateralizes its exposures at a CCP, the bank should not be required to include the overcollateralization in the leverage ratio since that collateral is again held at the CCP and is not available for the bank to leverage themselves.

Treatment of Other Off-Balance Sheet Exposures - Commitments to Liquidity Facilities

The BCBS 251 text states in sections 40 & 41 that banks must include commitments to liquidity facilities in the Exposure Measure by applying a 100% credit conversion factor. In contrast the CFTC and Federal Reserve Bank are taking a position that US CCPs must have committed liquidity facilities to support the liquidity of all collateral except cash in adopting CPSS-IOSCO PFMI 7. CME has significant concerns that these conflicting regulations will have the perverse impact of increasing demand for committed liquidity facilities at the same time banks are seeking to reduce their committed facility exposures.

CPSS-IOSCO Principle 7: Liquidity states, *"For the purpose of meeting its minimum liquid resource requirement, an FMI's [financial market infrastructure] qualifying liquid resources in each currency include cash at the central bank of issue and at creditworthy commercial banks, committed lines of credit, committed foreign exchange swaps, and committed repos, as well as highly marketable collateral held in custody and investments that are readily available and convertible into cash with prearranged and highly reliable funding arrangements, even in extreme but plausible market conditions."* PFMI 7 clearly places heavy reliance on committed facilities and we expect that local regulators will adopt regulations that are similar in nature. As regulatory bodies are placing more reliance on bank commitments as one of limited "qualifying" liquid resources for an FMI, it seems counterintuitive that global standards setters would in turn increase the costs for banks providing committed liquidity to an FMI. In addition to the potentially constrained environment for committed facilities due to the capital charges associated with these facilities, banks will likely migrate capacity to those that are consistently drawn for operational purposes within the broader economy, rather than CCP facilities drawn only in crisis, due to the increased fees received on drawn facilities. See Appendix II for our recent remarks to CFTC reg 39.33, highlighting issues related to CPSS-IOSCO Principle 7 implementation in the United States.

Another qualifying liquidity resource under the CFTC proposal is cash. Unfortunately, BCBS 253 is proposing more punitive capital requirements for initial margin collateral posted against derivatives exposures that cannot be considered bankruptcy remote from the CCP's insolvency. Preliminary analysis by numerous market participants indicates that use of cash collateral to satisfy a FMI's margin or guaranty fund requirements may present difficulties from a bankruptcy remoteness standpoint.

Consequently, banks may be incentivized to use alternative forms of collateral such as securities to satisfy a FMI's margin or guaranty fund requirements. This would in turn re-enforce the need for the FMI to obtain larger amounts of committed facilities. Under the proposed 251 standard, CME has significant concerns that adequate bank capacity to provide committed liquidity facilities to FMI's may simply not be available – at any price. Such facilities may be more expensive for a bank from the point of view of capital charges and leverage requirements; even if these costs are not an issue, we understand that committed facility exposure must be captured in the bank's single counterparty credit exposure limit calculations with respect to any CCP beneficiary of such a facility.

(II) Items for Clarification

The BCBS 251 text states in section 23 that banks must calculate their derivatives exposures as the replacement cost for the current exposures plus an add-on for potential future exposure. When calculating these derivatives exposures, it appears that bilateral exposures for derivatives exposures must only be calculated once (i.e. one trade leg) while exposures for agency client clearing must be counted twice, to purportedly account for two legs of exposure.

We assume that the BCBS proposal for agency customer clearing requires two trade legs based on an assumption that one leg represents the trade between the customer and the bank and one leg that represents the trade between the bank and the CCP. This would incur a leverage charge on each leg for margin and potential future exposure because each trade is with a different legal entity. As an example:

	Uncleared	Cleared
	Margined *	Agency Model
Margin Collateral between Client & Bank FCM	2,250,000	1,500,000
Potential Future Exposure** between Client & Bank FCM	225,000	150,000
Margin Collateral between Bank FCM & CCP	-	1,500,000
Potential Future Exposure between Bank FCM & CCP	-	150,000
Default Fund Contribution+ between Bank FCM & CCP	-	75,000
Gross Exposure for Leverage Ratio (Sum of Above)	2,475,000	3,375,000
Leverage Ratio Exposure (3%)	74,250	101,250

**Margin for Uncleared = 1.5* Margin for Cleared based on 5 Day // 10 Day MPOR*
***Potential Future Exposure = 10% of Margin*
+ Default Fund Contribution = 5% of Margin

However, in the agency model, the clearing member does not guarantee the financial performance of the CCP to the client in the event the CCP fails to perform to the clearing member. The clearing member is only responsible for performing to the client when the CCP performs to the clearing member. Therefore, the bank's leverage exposures should only reflect one leg of exposure, the leg from the client to the bank, similar to the bilateral model. Conversely, in the principal-to-principal clearing model, to the extent the clearing member does guarantee the financial performance of the CCP to the client in the event the CCP fails to perform to the clearing member, the bank's leverage exposures should reflect two legs of exposure rather than the BCBS proposal to require three legs of exposure. However, we

understand that the common practice in the market is that the banks do not legally guarantee such financial performance of the CCP to their clients.

Assuming a multi-leg treatment for centrally cleared exposures, the leverage ratio exposures for central clearing would become significantly higher than that of a similar uncleared, margined position because the clearing exposure would be doubled under the agency model (and possibly, under the principal-to-principal clearing model depending on the contractual arrangements between the banks and their clients). Based on the past statements by BCBS where it offers its support for the central clearing of standardized OTC products, this cannot be the intent behind BCBS 251. As such, we believe the BCBS should amend the requirements for calculating exposures for central clearing to avoid discouraging central clearing.

Conclusion

CME reiterates its appreciation for the opportunity to comment on the significant efforts expended by the Committee to strengthen the banking industry and provide transparent means of comparison within the industry to the public.

Our general concern is that, taken together, BCBS 251, 253, and 254 as well as other BCBS proposed standards, including single counterparty limits to QCCP exposures, will result in the cost to clear being significantly higher and more restrictive than the cost to pursue a strategy that does not require clearing. Such an outcome would be counter to the G20 and the BCBS commitments toward clearing standardized OTC products and could potentially result in market participants avoiding central clearing by developing products with slight variations that are not mandated to be cleared.

CME would like to thank the Committee for the opportunity to provide these comments. We would be happy to further discuss and clarify any of the above issues with the Committee. If you have any comments or questions regarding this submission, please feel free to contact Kim Taylor, President, CME Clearing at (312) 930-3156 and Kim.Taylor@cmegroup.com or Tim Doar, Managing Director and Chief Risk Officer at (312) 930-3162 and Tim.Doar@cmegroup.com or Lee Betsill, CEO, CME Clearing Europe at (44) 203 379 3120 and Lee.Betsill@cmegroup.com.

Sincerely,

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Appendix I - EMIR Regulation (EU) No 648/2012, Art. 39

Article 39

Segregation and portability

1. A CCP shall keep separate records and accounts that shall enable it, at any time and without delay, to distinguish in accounts with the CCP the assets and positions held for the account of one clearing member from the assets and positions held for the account of any other clearing member and from its own assets.

2. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions of that clearing member from those held for the accounts of its clients ('omnibus client segregation').

3. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients ('individual client segregation'). Upon request, the CCP shall offer clearing members the possibility to open more accounts in their own name or for the account of their clients.

4. A clearing member shall keep separate records and accounts that enable it to distinguish both in accounts held with the CCP and in its own accounts its assets and positions from the assets and positions held for the account of its clients at the CCP.

5. A clearing member shall offer its clients, at least, the choice between omnibus client segregation and individual client segregation and inform them of the costs and level of protection referred to in paragraph 7 associated with each option. The client shall confirm its choice in writing.

6. When a client opts for individual client segregation, any margin in excess of the client's requirement shall also be posted to the CCP and distinguished from the margins of other clients or clearing members and shall not be exposed to losses connected to positions recorded in another account.

7. CCPs and clearing members shall publicly disclose the levels of protection and the costs associated with the different levels of segregation that they provide and shall offer those services on reasonable commercial terms. Details of the different levels of segregation shall include a description of the main legal implications of the respective levels of segregation offered including information on the insolvency law applicable in the relevant jurisdictions.

8. A CCP shall have a right of use relating to the margins or default fund contributions collected via a security financial collateral arrangement, within the meaning of Article 2(1)(c) of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (1) provided that the use of such arrangements is provided for in its operating rules. The clearing member shall confirm its acceptance of the operating rules in writing. The CCP shall publicly disclose that right of use, which shall be exercised in accordance with Article 47.

9. The requirement to distinguish assets and positions with the CCP in accounts is satisfied where:

   (a) the assets and positions are recorded in separate accounts;

   (b) the netting of positions recorded on different accounts is prevented;

(c) the assets covering the positions recorded in an account are not exposed to losses connected to positions recorded in another account.

10. Assets refer to collateral held to cover positions and include the right to the transfer of assets equivalent to that collateral or the proceeds of the realisation of any collateral, but does not include default fund contributions.

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Appendix II – Attachment "CME Liquidity Comment Letter 09162013"