



Via E-Mail (BaselCommittee@bis.org)

Sept. 27<sup>th</sup> 2013

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

**RE: BCBS 253 Consultative Document: *Capital treatment of bank exposures to central counterparties***

CME Group Inc. ("CME Group"), on behalf of its subsidiaries, Chicago Mercantile Exchange Inc. ("CME") and CME Clearing Europe Limited ("CME Clearing Europe"), would like to express appreciation to the Basel Committee on Banking Supervision ("BCBS") for the opportunity to comment on BCBS Consultation: *Capital treatment of bank exposures to central counterparties* ("BCBS 253").

CME Group is the parent of five Designated Contract Markets ("DCMs"): the CME, the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), the Board of Trade of Kansas City Missouri, Inc. ("KCBT") and the Commodity Exchange, Inc. ("COMEX"). These DCMs 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 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 in the United Kingdom and is in the process of being reauthorized under the European Market Infrastructure Regulations. 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 supports the efforts of BCBS to propose banking standards that promote the stability of the global financial system and believes such standards should support the commitments made by the G-20 and the BCBS to move standardized OTC products into a centrally cleared environment. In addition, CME Group believes all proposed standards should be designed in a way that properly reflects the risks that different bank exposures pose to the financial system. In particular, the capital charges on bank contributions to CCP default funds, which are designed to address tail risk, should be aligned with the risk of a drawdown of such contributions by a CCP. We also believe it is illogical and damaging to use the size of default funds up to a regulatory minimum ("Cover \*") as a mechanism to impose capital charges on bank exposures since default funds are sized based on a tail loss estimate whereas capital requirements are typically based on a risk weighted expected exposure measure. Ideally, the BCBS should propose a risk weighting standard that is reasonable when compared to the risk weightings on

other bank exposures such as structured debt and is sized based on a measure of risk that is consistent with a risk based capital framework.

The proposals contained in BCBS 253 are particularly concerning when viewed in conjunction with BCBS 251 Consultative Document: *Revised Basel III leverage ratio framework and disclosure requirements* ("BCBS 251") and BCBS 254 Consultative Document: *The non-internal model method for capitalizing counterparty credit risk exposures* which, if implemented in local jurisdictions 'as is', will also impose increased costs on banks, and otherwise damage CCP's efforts to develop sensible risk management frameworks. Thus, CME is concerned that BCBS 253, taken together with other proposed BCBS standards relating to NIMM, the leverage ratio, and single counterparty credit limits, may disincentivise central clearing, and increase systemic risk. These BCBS proposals generally appear to impose onerous capital charges and constraints for central clearing which make central clearing more expensive as compared to economically equivalent margined, bilateral transactions. CME Group is particularly sensitive to how the BCBS consultative proposals, if enacted into binding regulation in local jurisdictions, will negatively impact the regulatory capital profiles associated with the clearing of OTC and exchange-traded products and disincentivise the use of CCPs. This result directly contradicts the stated objectives of BCBS 253 of "support[ing] the broader G20 mandate to promote central clearing of OTC derivatives as a way to reduce systemic risk..."<sup>1</sup> and "provid[ing] an incentive for, or at least not discourage[ing], contributions to default funds to be prefunded, rather than commitments to pay ex post."<sup>2</sup>

Please note that we will also specifically address the questions posed by BCBS in section 5 below.

#### **1. Weighting on Bank Exposures to CCPs Lack of Risk Sensitivity**

One of the purported goals of BCBS 253 is to apply a risk weighting to bank default fund contributions that is risk sensitive. In discussing this goal, the BCBS accurately states that risk weights should be varied based on the size of the contributions to a default fund since "[t]he risk to a QCCP member of suffering a complete loss of their contributions to a default fund that is many times larger than the regulatory minimum must be lower than the risk of suffering a complete loss of their contribution if the same CCP held a much smaller default fund, however we note that the capital regulation as proposed strongly incents a smaller default fund through the punitive 1250% risk weight."<sup>3</sup> The statement that the risk of complete loss decreases as default fund contributions increase is a reasonable observation that should be employed to sensibly craft an approach to capital charges for bank contributions to CCP default funds is undoubtedly true. Unfortunately, BCBS 253 fails to account for the remote likelihood that a non-defaulting bank clearing member suffers any loss on their default fund contribution by applying a punitive, and inappropriate, risk weight to default fund contributions at a level up to Cover \*. To the extent that the NIMM requires a default fund in excess of Cover \*, this onerous risk weighting could be applied to an even greater

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

<sup>2</sup> *Id.* at ¶ 14(iv).

<sup>3</sup> *Id.* at ¶ 21.



exposure than that represented by Cover\*.<sup>4</sup> By way of example, the BCBS has proposed a 1250% risk weighting to default fund contributions up to Cover \* or NIMM, whichever is greater. Based on a standard 8% capital ratio, this translates into a 100% capital charge for default fund contributions up to the level of Cover \* which effectively assumes that all clearing members will lose their entire default fund contribution at every CCP in a given year.<sup>5</sup> To say that the risk of such a default scenario occurs is negligible would be a significant understatement.

Unfortunately, the risk weighting applied to default fund contributions fails to account for the minimal risk of a non-defaulting clearing member's contribution being drawn down by CME or another QCCP. Generally, the default fund contribution of a non-defaulting clearing member is quite unlikely to be used in the case of another clearing member's default due to the clearing default waterfall structure in place at most, if not all, CCPs and the senior placement of non-defaulting member contributions in the risk waterfall. In the case of CME, the flow of the waterfall when a default occurs is as follows:

- (i) Defaulting Clearing Member's initial margin (sized to address 99%+ of product volatility over a given close out period);
- (ii) Proceeds from sale of Defaulting Clearing Member's assets posted with CME and defaulting Clearing Member's Default Fund Contribution (default fund stress tests cover longer periods of product volatility using 30+ years of history);
- (iii) CME Contribution to Waterfall;
- (iv) Pro rata drawdown of Non-defaulting Clearing Member Default Fund Contributions; and
- (v) Pro rata assessments against non-defaulting Clearing Members.

Most CCP's, and CME in particular, have long relied upon the use of margin collateral (which in the US must be sized to a 99% standard) and daily mark-to-market (or 'variation margin') as effective means to remove or mitigate market risk. In the case of CME, variation margin and initial margin are binding on both the buyer and seller of the derivative instrument; this fundamental risk management arrangement has proven to be a highly effective combination for 'containing' risk to individual clearing firms in market stress scenarios. CME will first look to the defaulting clearing member's initial margin to cover any monies owed following the liquidation of their portfolio. Assuming the initial margin isn't sufficient, CME will then liquidate other of the defaulting clearing member's assets posted with CME and the defaulting clearing member's default fund contribution to address any shortfalls. To date, CME has never been forced to liquidate assets in the second and third tier of the waterfall in any default scenario, not only in the most recent credit crisis and the

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<sup>4</sup> Based on our initial analysis of NIMM which we will detail in a separate letter, we do not believe it likely that NIMM will be higher than Cover \* for any CCP.

<sup>5</sup> Cover \* can be Cover 1 or Cover 2 depending on the jurisdiction and whether a CCP is deemed systemically important. Cover 1 and Cover 2 represent whether a CCP's default fund needs to be large enough to default of its single largest clearing member exposure or its first and second largest clearing member exposure. CME will be subject to a Cover 2 requirement as of January 1, 2014.

bankruptcy of Lehman Brothers, but dating back to the the crash of 1987, Drexel Burnham Lambert, the Barings Bank collapse, the Refco bankruptcy, the fall of Long-Term Capital Management, and MF Global.<sup>6</sup> Thus, variation margin and initial margin, taken together with other elements of the risk waterfall, have proven to provide an extremely effective ‘buffer’ between the risk the clearing house faces with individual firms, relative to the risk that all firms face to any potential claim the clearing house may have on their default fund contributions. In this context, it is disconcerting that the BCBS would propose a risk weighting to banks’ default fund contributions that equates the CCP default fund risk profile to that of a junk bond.

For example, the second tier of the default waterfall (defaulting clearing member contributions), which must be completely exhausted before the next tiers of the default waterfall are drawn down (CCP contributions and then non-defaulting clearing member contributions), was not utilized by CME during CME Clearing’s liquidation of the Lehman Brothers ‘house’ portfolio in September 2008, and has never been used in any other scenario in the history of CME.<sup>7</sup> Considering the fact that defaulting clearing member assets posted with CME and CME corporate contributions to the waterfall must be exhausted prior to CME using a non-defaulting member default fund contribution, non-defaulting clearing member contributions were not close to being drawn down even during the worst financial crisis since the Great Depression. The seniority of non-defaulting member contributions in the default waterfall and the safety of default fund contributions during the financial crisis illustrate the error of applying the proposed 1,250% risk weighting to default fund contributions. As noted by Athanassios Diplas when speaking at the International Swaps and Derivatives Association European Conference in 2013, “[t]o use an analogy, this is like taking a super-senior tranche of CDO, but treating it like the first-loss equity tranche. [It] is illogical and creates perverse incentives, and makes it very difficult for firms to provide clearing services for clients.”<sup>8</sup>

The disconnect between the risk of a QCCP clearing member losing their entire default fund contribution and the risk weighting applied to such contributions comes starkly into focus when comparing it to the risk weightings assigned to other bank exposures. Due to the structured nature of the risk waterfall (in contrast to general corporate debt), we believe that the best corollary to default fund contributions are the risk weights applied to structured finance instruments. As noted above, CME has never been forced to use a non-defaulting clearing member’s default fund contribution to protect the marketplace against the default of a fellow clearing member. In fact, CME has never used its own contributed capital in such circumstances and its contributed capital is junior to the mutualized default fund in the risk waterfall.

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<sup>6</sup> The CME Clearing House began its operations in 1919.

<sup>7</sup> We further understand that default funds have rarely, if ever, been drawn down by any CCP and would suggest that where it may have occurred many years ago that such CCPs were not subject to the same level of regulatory oversight as QCCPs.

<sup>8</sup> Athanassios Diplas, Sr. Advisor to ISDA Bd., Remarks at the International Swaps and Derivatives Association Annual European Conference in London (Sept. 19, 2013).



Unsurprisingly, the default rate on structured finance securities, whether AAA, investment grade or speculative grade, is higher than the zero percent effective default rate for non-defaulting clearing member contributions at CME<sup>9</sup>. Table 1 on Page 5 provides a clear illustration of the greatly differing risk profiles between CME default fund contributions and structured finance securities during times of market stress. Despite the riskier profile of AAA and Investment Grade structured finance securities and the significantly riskier profile for Speculative Grade structured finance securities, all of these instruments receive a much more favorable risk weighting than that of historically safer default fund contributions under the proposed Basel III standards. When forced to look for a comparative asset for CME default funds, the instrument with a risk profile nearest is a AAA Structured Finance Security despite its history of defaults.

In 2008 and 2009 respectively, AAA Structured Finance Securities<sup>10</sup> defaulted at rates that were .52% and .29% higher than the 0% effective default rate on contributions to the CME default fund. As such, we believe that the risk weighting on default fund contributions should be no more than the 20% risk weighting applied to AAA Structured Finance Securities. Failing to make this change would result in a risk weighting on default fund contributions that is 265% higher than risk weightings on Speculative Grade Structured Finance Securities, 1,059% higher risk weightings than Investment Grade Structured Finance Securities and 6,250% higher than risk weightings on AAA Structured Finance Securities (the closest, albeit more risky, comparative asset). Focusing on speculative grade structured finance securities, it is difficult to imagine that the intent of the BCBS was to place risk weights on CCP default funds double that of the speculative grade structured finance securities given their recent history of record levels of default. These elevated risk weightings could incentivize banks to find ways to continue to operate in the cheaper, uncleared market rather than transition to a centrally cleared environment which conflicts with the goals of G-20 and BCBS and could potentially increase systemic risk.

	2008		2009		Basel III Risk Weight % <sup>2</sup>	
	Default Rate <sup>1</sup>	Default and Near Default Rate <sup>1</sup>	Default Rate <sup>1</sup>	Default and Near Default Rate <sup>1</sup>	Maturity	
					1y	5y
CME Guaranty Funds	0.00%	0.00%	0.00%	0.00%	1250%	1250%
AAA Structured Finance Security	0.52%	1.84%	0.29%	0.80%	20%	58%
Investment Grade Structured Finance Security (BBB for Basel III table)	1.03%	6.23%	2.61%	8.16%	118%	203%
Speculative Grade Structured Finance Security (CCC for Basel III table)	16.09%	36.24%	38.52%	56.02%	472%	568%

2008 & 2009 Represent Highest Structured Finance Default Periods since 1990 according to S&P Report

<sup>1</sup> S&P: Global Structured Finance Default Study, 1978-2012: A Defining Moment For Credit Performance Stability

<sup>2</sup> BCBS236: Revision to the Basel Securitisation Framework ; Table 2 - Illustrative Revised RBA risk weights under hierarchy A(%) & BCBS253: Capital treatment of bank exposures to central counterparties

<sup>9</sup> Under a clearing member default scenario, all junior portions of the waterfall including defaulting members margin, defaulting members default fund contributions and other collateral on deposit, and CCP contributions to the waterfall, must be fully drawn prior to any draw down of the mutualized default fund contributions from non-defaulting members. Even in times of significant market stress, a clearing member default would likely lead to only the partial use of non-defaulting members default fund contributions, similar to how a AAA structured finance default where the default amount would be net of a recovery value on the underlying assets behind the security. The similarities between these scenarios provided us with additional comfort that structured securities are the best corollary to default funds. Further, this is why we use “effective default rate” for our comparison.

<sup>10</sup> We are only including AAA Structured Finance Securities that were not already in default or near default.



## **2. Use of Cover \* Exacerbates Issues with Default Fund Risk Weightings**

The negative consequences of applying a 1,250% risk weighting to default fund contributions are exacerbated by using Cover \* as a sizing mechanism for risk exposures. Cover \* addresses the extreme tail risk of the default of the 1 or 2 largest clearing members of a CCP. Conversely, traditional capital requirements are risk weighted by their nature so banks have the requisite capital on hand to withstand the risks presented by their regular business activities. Applying a 1,250% risk weighting, or 100% capital charge, to a contribution designed to address tail risk assumes complete loss of a contribution that by its nature is designed to address extreme scenarios. In other words, this assumes a 100% probability that the default fund would be 100% drawn, a seemingly extreme event compounded on an already extreme measurement.

While CME Group strongly believes that the BCBS must reconsider the capital charge and associated risk weighting on default fund contributions to accurately account for the risk that a CCP will need to draw on its default fund (as explained in more detail in Section 1), it would also be prudent for the BCBS to reconsider the use of a tail risk calculation as a sizing mechanism for what is purported to be a risk weighted exposure calculation. Note that CME only supports the removal of Cover \* as a mechanism for calculating exposures to the extent that its suggested changes to NIMM are incorporated into the final BCBS standards.

## **3. Proposed Treatment of Default Fund Contributions Disincentivizes Central Clearing**

As outlined above, the proposed risk weighting and associated capital charge for default fund contributions along with the use of Cover \* as an exposure calculation method fails to appropriately capture the risk profile dynamics of CCP of CCP risk management regimes, and the placement of default funds in CCP waterfalls. Moreover, the 1250% risk weighting and 100% capital charge can be seen to significantly disincentivize central clearing by making it more expensive than the margined, uncleared market for banks. Consequently, the excessive cost proposed for default fund contributions conflicts with the following commitment made by the G-20 leaders in September 2009: “[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.”<sup>11</sup> In addition, the Macroeconomic Assessment Group on Derivatives, chaired by Stephen G. Cecchetti of the Bank for International Settlements, released an assessment in August 2013 which clearly indicates that the OTC derivatives reforms requiring the transition of standardized products to central clearing will reduce the likelihood of a financial crisis by lowering OTC derivatives exposures “through collateralisation and through multilateral netting brought about by central clearing.”<sup>12</sup> BCBS has also supported the

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<sup>11</sup> Fin. Stability Bd. Press Release, Financial Stability Board Releases Report on Improving OTC Derivatives Markets 2 (Oct. 25, 2010), available at [http://www.financialstabilityboard.org/press/pr\\_101025.pdf](http://www.financialstabilityboard.org/press/pr_101025.pdf).

<sup>12</sup> Macroeconomic Assessment Grp. Derivatives, *Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reform* 21 (August 2013).

move to central clearing of standardized derivatives repeatedly<sup>13</sup> including in this very consultation paper where it is stated that “[t]he objective of the suggested changes is to establish a capital treatment that ensures banks’ exposures to central counterparties are adequately capitalised, while also – in support of the G20 mandate to clear centrally all standardised over the counter derivatives – preserving incentives for central clearing....” The BCBS went further in paragraph 16 of BCBS 253 by stating that it did not intend for the capital charges applied to central clearing to exceed “the level of capital that would be required if the same trades were executed bilaterally and were not centrally cleared.”<sup>14</sup> The inappropriate risk weighting proposed by BCBS for default fund contributions fails on all accounts.

In order to demonstrate the inordinate impact on cost to clear of the 1,250% risk weighting on default fund contributions, we have calculated the traditional capital charges applied to an uncleared trade with no margin, uncleared trade with margin and a cleared trade based on some simple assumptions. Appendix 1 includes the detailed analysis of capital costs for cleared and uncleared trades but the most important assumptions are: (1) an interest rate swap trade notional value of \$150,000,000, (2) bankruptcy remoteness of initial margin, (3) margin period of risk of 5 days for cleared trades, (4) margin period of risk of 10 days for uncleared trades, (5) cleared trade exposure risk weight of 5%, (6) uncleared trade exposure risk weight of 50%, (7) default fund risk weight of 1,250% and (8) a default fund equal to 5% of initial margin<sup>15</sup>. We believe that all of these assumptions (and the rest of those made in Appendix 1) are reasonable based on our understanding of the proposed Basel III regulations and clearing market conventions (i.e. default fund contribution equal to 5% of initial margin).

The first number that jumps out from a cursory review of the Traditional Capital Charge table from Appendix 1 is \$75,000. This is the default fund capital charge associated with the clearing of a \$150,000,000 interest rate swap. In contrast, the trade exposure capital requirement for an uncleared, margined trade is \$2,701 and for a cleared trade is \$891. Thus, the difference between the capital charge on trade exposures for uncleared, margined trades and cleared trades of \$1,810 represents approximately 2.4% of the \$75,000 capital charge imposed on the default fund contribution for the cleared transaction. As a result, the \$75,891 traditional capital charge imposed on the cleared transaction is over 28 times larger than the \$2,701 traditional capital charge imposed on a similar uncleared, margined transaction.<sup>16</sup>

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<sup>13</sup> BCBS also espoused the goal of giving “effect to the G20 Pittsburgh statement concerning the creation of incentives for banks to increase the use of CCPs” in a December 2010 consultative document. See Basel Comm. Banking Supervision, *Consultative Document: Capitalisation of Bank Exposures to Central Counterparties* ¶ 1 (Nov. 25, 2011), available at <http://www.bis.org/publ/bcbs206.htm>.

<sup>14</sup> BCBS *supra* note 1, at ¶ 16.

<sup>15</sup> Default funds at CCP’s are sized based on stress tests, the “% of initial margin” here is merely a crude proxy used for example purposes.

<sup>16</sup> We have not included any CVA charged on the uncleared, margined transactions but based on our initial analysis we are confident that it would have a negligible impact on the capital cost differential between cleared and uncleared, margined transactions in this example.



A capital charge difference of this magnitude will strongly incentivize banks to operate in the uncleared, margined market whenever possible and potentially undermine the efforts of governments and regulators around the world to move standardized OTC products to a centrally cleared environment. Further, it may result in bank affiliated clearing members being less likely to clear customer business.<sup>17</sup> We do not believe that frustrating the transition of standardized OTC products to central clearing was the intent of the BCBS so we would suggest a risk sensitive capital charge for default fund contributions in line with the capital charge applied to AAA Structured Finance Securities. If the 20% risk weighting applied to 1 year maturity AAA Structured Finance Securities was used for default fund contributions, the capital charge on the default fund contribution of \$75,000 in the above scenario would be reduced to approximately \$1200. This in turn would result in a capital charge for the cleared trade of \$2,091 or \$610 less than the uncleared, margined trade. Not only would the reduced capital charge be appropriately risk sensitive, it would also result in a lower capital charge for cleared transactions which would contribute to the goal of the G-20, the BIS, the BCBS and regulators throughout the world to move standardized OTC products to a centrally cleared environment.

#### **4. Default Fund Sizing and Clearing Member Skin in the Game**

In Section 14(iv) of BCBS 253, the BCBS expresses its intent to “provide an incentive for, or at least not discourage, contributions to default funds to be prefunded, rather than commitments to pay ex post.”<sup>18</sup> The application of a 1,250% risk weighting to default fund contributions strongly disincentivizes prefunded default fund contributions. Conversely, it encourages increased ex post commitments to pay into default funds and a rebalance of CCP’s risk mitigation techniques favoring increases to initial margin requirements and decreases to default fund sizing. We believe that ex post commitments to pay into default funds are less reliable than prefunded default fund contributions in times of market stress which increases the overall systemic risk to the market.

Additionally, decreasing the size of the obligations of clearing members to make prefunded contributions to default funds reduces their incentive to maintain prudent risk management standards when monitoring their house and client exposures.<sup>19</sup> The current structure whereby CCP default funds typically range from 3% to 6% of initial margin for established markets has historically resulted in clearing members, who along with the CCPs have the most expertise in risk management, being quite cautious in the amount of risk they accept. The fact that CME has never been forced to draw down the default fund contribution of a clearing member (defaulting and non-defaulting) strongly evidences the successful clearing member risk management incentives of the current risk management structure. We are very concerned that the potential reduction in default fund sizing resulting from the proposals in BCBS 253 will have the perverse effect of limiting the incentives for

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<sup>17</sup> Thus denying many clients access to the risk mitigating benefits of central clearing.

<sup>18</sup> BCBS 253, *supra* note 1, at 3 § 14(iv).

<sup>19</sup> Smaller default funds could adversely affect peer monitoring and CCP monitoring by banks because of their smaller size. Additionally, smaller default funds would likely affect the competitive bid process at defaulted portfolio auctions because the smaller scale would affect the incentives for non-defaulting members to bid aggressively on those portfolios.



clearing members to closely risk manage their exposures (for fear of a default fund draw down). This in turn could increase systemic risk in the market which will increase the likelihood that a clearing member loses its default fund contribution.

## 5. BCBS Questions

Q1: Which of these two proposed methodological approaches (tranches or ratios) best satisfies the objectives which the capital treatment seeks to achieve and why?

*Internal analysis of the two approaches has shown minimal difference between the two. While the ratio's approach follows a more straight-forward and algebraic methodology, the tranche's approach tends to more accurately reflect the actual cascading effects of a clearing member default. The issue remains in either case that the end result is a drastic overestimation of the capital required for prefunded clearing member contributions to the default fund at a QCCP.*

Q2: What are the pros and cons of using the greater of the minimum Cover\* level required by the CPSS-IOSCO PFMI or the hypothetical level of default resources calculated using NIMM as a model for calculating the relative risk of clearing members contribution to QCCP default funds? Should the Committee consider any adjustments to NIMM to improve its measurement of derivative exposures in the context of CCPs? Would it be better to use only one of these measures, or are there other suitable alternatives?

*We have separately commented on the BCBS NIMM consultative document (CME's NIMM comment letter is attached as Appendix 2 hereto), in which we have identified main concerns around the treatment of non-linear instruments, the punitive approach towards commodities derivatives, and the lack of offsets amongst currencies as our main concerns. If these were amended in the NIMM approach, we may be able to reach a level of comfort with NIMM as a method for sizing the default fund exposure at which capital charges are applied.*

Q3: What risk weights / capital charges would best achieve, or appropriately balance, the objectives set out in Section II.C? In particular, how would possibly lower values ensure that clearing members are capable of absorbing losses in times of stress without the drawing down of the default funds threatening the viability of the non-defaulting members who have contributed to them? How would the proposed 1250% risk weight affect incentives to use central counterparty clearing?

*The threat of a draw down on default fund contributions from non-defaulting members is a risk that should be recognized through a risk sensitive approach towards the default fund. The proposed 1250% is not a risk sensitive measure as it requires all non-defaulting members to brace for a complete loss on their default fund contributions. The probability of this event should be accounted for in the risk weight of the default fund, similar to how it is incorporated in the risk weight of other bank securities. In times of significant market stress, a clearing member default would likely lead to only the partial use of non-defaulting members default fund contributions, similar to how other securities would have a recovery value on the underlying assets behind the security. This is why we believe a more risk appropriate weighting on the default fund of 20% is in line with the actual*

*probability and final amount of a non-defaulting clearing member default fund contribution draw down during a clearing member default.*

*Please refer to CME's analysis and recommendation in the sections above.*

Q4: The Committee invites comments on this potential risk sensitive approach to capitalising trade exposures to CCPs.

*A risk sensitive approach to capitalizing trade exposures is sound in theory; however in practice the BCBS current proposals offer no incentives for clearing members to overfund CCP default funds. Thus, we would anticipate a fully funded CCP default fund to result in a trade exposure risk weight of near 5%, effectively 2.5 times the 2% originally proposed in BCBS 227. We would ask the BCBS to re-think their approach in this light, and to evaluate the lack of incentives for clearing members to overfund CCP default funds.*

Q5: Do you consider it appropriate to treat initial margin, where a QCCP has legally enforceable rules that make initial margin a senior claim to variation margin in the event of losses in excess of default resources, differently from other trade exposures by retaining a fixed 2% risk weight on initial margin posted in a non-insolvency remote manner?

*CME has no comment in response to this question.*

Q6: Do the proposed approaches to capture commitments to top up default funds in the capital treatment of exposures to QCCPs satisfy the objectives which the capital treatment seeks to achieve? Are there ways in which the proposed capital treatment of commitments could be improved? Is the proposed  $\alpha$  value of 0.5 appropriate?

*After evaluating the BCBS recommended approaches, we have found that the balance of achieving a perfect offset of these two charges will rely upon sizing the relationship between default funds and trade exposures at QCCP's. This relationship is intended to be captured through the "alpha" factor currently proposed at .5, which works to adjust the risk weight for trade exposures. We implied from the BCBS 253 text that the Basel committee will seek to calibrate this alpha factor using the data provided during the September 2013 Joint QIS study. We have many concerns that a one-time calibration of this alpha factor could lead to potential adverse effects to clearing member's capital charges in the future. We would ask the BCBS to reconsider their proposed approach, and additionally to decide if it is prudential to assign these charges at all when the intended result is designed to produce no additional capital charges to member firms.*





## 6. Conclusion

CME Group reiterates its appreciation to the BCBS for the opportunity to comment on BCBS 253. We strongly support the application of appropriate, risk sensitive capital charges to bank QCCP exposures as a way to reduce systemic risk. However, we firmly believe that capital charges for QCCP exposures should be appropriate in the context of the risk posed by particular exposures and should be calculated based on a bank's risk weighted exposure. We are greatly concerned that BCBS 253, particularly in conjunction with BCBS 251, fails to properly account for the minimal risk of default fund contributions and proposes a calculation method based on Cover \* that is an inappropriate metric for determining bank capital needed to address risk exposures. In order to address these issues, the BCBS should revise BCBS 253 so it:

1. Applies an appropriate risk weight of approximately 20% for default fund contributions that encourages central clearing and aligns with the risk weight applied to exposures with a similar structure and risk profile such as 1 year maturity AAA Structured Finance Securities; and
2. Eliminates the inappropriate use of Cover \* as a calculation method for bank default fund exposures.

Adopting BCBS 253 in its current form contradicts the goals of the BCBS and the G-20 and will lead to increased systemic risk by encouraging banks to create economically equivalent products that can be traded in the bilateral market. It may also have a negative impact on the overall risk management for centrally clearing by shrinking the size of default funds and in turn reducing the incentives for clearing members to manage their risks in a prudent manner.

We would be happy to further discuss and clarify any of the above issues with the BCBS. If you have any comments or questions regarding this submission, please feel free to contact Kim Taylor, President, CME Clearing at +1 312 930-3156 and [Kim.Taylor@cmegroup.com](mailto:Kim.Taylor@cmegroup.com) or Tim Doar, Managing Director and Chief Risk Officer at +1 312 930-3162. Alternatively, you may contact Lee Betsill, CEO, CME Clearing Europe at +44 203 379 3120 and [Lee.Betsill@cmegroup.com](mailto:Lee.Betsill@cmegroup.com).

Sincerely,

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## APPENDIX 1

### Cleared vs Uncleared Analysis

Assumptions	Interest Rate Swap
Trade Notional	150,000,000
Trade Tenor (Year)	1
No Margin Add-On	0.50%
Margin Requirement (% of Notional)	1.00%
MPOR Requirement (Days) - Cleared	5
MPOR Requirement (Days) - Uncleared	10
5 Day // 10 Day MPOR Margin Differential	1.50
Current Market Value	1,500,000
IM held @ QCCP as Bankruptcy Remote (Y/N)	Y
IM Risk Weight @ QCCP if held Non-BR	2%
Floor % for PFE (From BCBS text)	5%
Alpha (From BCBS text)	1.4
Default Fund Contribution as % of IM	5%
Cleared Trade Exposure Risk Weight	5%
Uncleared Trade Exposure Risk Weight	50%
Default Fund Risk Weight	1250%
Capital % (Standard)	8%

### Traditional Capital Charge

	Uncleared		Cleared	
	No Margin	Margined	Agency Model	Principal Model
Effective Notional	150,000,000	150,000,000	150,000,000	150,000,000
"AddOn" Based on NIMM SF Factor (No Margin)	750,000	750,000	750,000	750,000
Time Risk Horizon Scalar	100.0%	30.0%	21.2%	21.2%
NIMM Aggregate AddOn	750,000	225,000	159,099	159,099
Margin	0	2,250,000	1,500,000	1,500,000
Net Collateral	0	2,250,000	1,500,000	1,500,000
Current Market Value	1,500,000	1,500,000	1,500,000	1,500,000
Replacement Cost	1,500,000	0	0	0
Potential Future Exposure Multiplier	100%	21%	100%	100%
Potential Future Exposure	750,000	48,232	159,099	159,099
Exposure At Default (NIMM)	3,150,000	67,524	222,739	222,739
Capital Requirement for Exposure	126,000	2,701	891	891
Capital Requirement for Initial Margin @ QCCP	0	0	0	0
Default Fund Contribution	0	0	75,000	75,000
Capital Requirement for Default Fund	0	0	75,000	75,000
Total Capital Requirement	126,000	2,701	75,891	75,891

**Please Note:**

\*NIMM used for Potential Future Exposures Quantification

\*Assumes no Capital Charge for IM on Uncleared Trades (money rests at the bank)

\*Assumes no Metrics for Threshold / Minimum Transfer Amount / Independent Amount for Replacement Cost on Margined trades





## APPENDIX 2 (NIMM COMMENT LETTER)