



Via E-Mail (BaselCommittee@bis.org)

Sept. 27th 2013

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

RE: BCBS 254 Consultative Document: *The non-internal model method for capitalizing counterparty credit risk exposures.*

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 254 consultative document, taken together with other BCBS consultative documents such as the BCBS 251 and 253 consultative documents, will incentivize the clearing of clearable OTC derivatives, and otherwise impact the cost and risk profile of exchange traded derivatives. CME Group is particularly sensitive to how BCBS consultative proposals, if enacted into binding regulation in applicable jurisdictions, will impact or otherwise influence the regulatory capital profile associated with OTC derivatives as well as the CCP margining and guaranty fund levels required for centrally cleared derivatives. As a reminder, throughout the 2008 crisis and the crises preceding that, 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 have shown that the standards proposed through these consultative documents are conflicting, may disincentivize clearing, and would likely encourage standardized OTC products to remain un-cleared in the absence of mandates and, in the event of mandated clearing, would encourage product alterations to avoid mandates, thus re-enforcing the problems seen in the 2008 crisis for OTC derivatives. We believe the issues posed by these consultative documents can be broadly classed into at least two broad areas of concern: gross overestimation of the capital required for CCP default funds, and punitive charges for leverage for cleared client collateral that is by CFTC and EMIR definition prohibited from increasing the leverage of a banking institution.

Focusing on this consultative document, CME Group appreciates the Committee's work towards establishing risk sensitive, simple, and comparable regulatory framework for banking supervision. Our focus in this letter will be specific to issues we have identified in the BCBS 254 (NIMM) text.

Upon review of the BCBS 254 text, we would like to comment in the following order:

- (I) General Comments
- (II) Items for Clarification
- (III) Response to specific BCBS 254 Consultation questions

(I) General Comments

Supervisory Delta Adjustments for Non-Linear Instruments

The BCBS 254 text states in section 47 that the Supervisory Delta adjustment (δ) for all non-linear instruments (other than CDO tranches) will be +/- 0.5 depending on if the instrument is long or short in the primary risk factor.

We understand a flat delta may introduce a level of commonality for non-cleared non-linear instruments; however, for cleared non-linear instruments, the actual delta is readily available to the public and already incorporated into daily settlement prices for these cleared non-linear instruments. We believe the notion of a flat delta adjustment for all non-linear instruments is flawed and can introduce error into the quantification of exposures for cleared instruments. Financial markets have long accepted and incorporated actual delta adjustments into pricing arrangements for cleared instruments, and to take a step back in this framework for the sake of "simplicity" would be counterproductive.

Applying the same Supervisory Delta in the exposures quantification of non-linear instruments, irrespective of the actual value and risk of the instrument, does not comport with risk management best practices. To the extent actual delta information is publicly available and published by the CCP we

believe participants should be permitted to use these delta values in their exposures measures under the NIMM approach.

Therefore, we believe that the Supervisory Delta adjustment for a non-linear instrument should be based on market available information, with a flat +/-0.5 value employed only when market-based delta values are not available.

Supervisory Factors by Asset Classes in the NIMM text

We have reviewed the Supervisory Factors within the NIMM text and believe that the factors are overly punitive for commodity products. Additionally, the relationships suggested in the NIMM approach between interest rate derivatives, commodities derivatives, and equity derivatives are plainly different than the relationships proposed in BCBS 261: *Margin Requirements for Non-centrally cleared derivatives*.¹

NIMM applies a base Supervisory Factor of 0.5% for standard un-margined interest rate derivatives, while the base NIMM Supervisory Factor for non-electricity commodity products is 15%, or 30 times the 0.5% factor for the one year interest rate derivative. In contrast, BCBS 261 recommends that a 1 year interest rate derivative carry a 1% margin requirement while a commodity product carry a 15% requirement, implying a 15-to-1 ratio². This contrast is also apparent for equity index derivatives, 40-to-1 in NIMM and 15-to-1 in BCBS 261, equity single names, 64-to-1 in NIMM and 15-to-1 in BCBS 261, and also the electricity commodity class, 80-to-1 in NIMM and 15-to-1 in BCBS 261. In effect, NIMM applies a more punitive supervisory factor for certain products than recommended by the BCBS in other consultations.

BCBS should apply a consistent factor ratio between interest rate derivatives and other derivatives to avoid market confusion and ensure its approach is consistent. Based on our experience with market volatility, we believe a 15 to 1 relationship is more representative of the actual risk profile of the commodities products and equity derivatives products. The effect of an overly punitive NIMM Supervisory Factor for these asset classes would unfairly penalize firms more actively engaged in these markets. We hope that the results of the Joint Quantitative Impact Study will highlight the impact of this punitive and inconsistent approach towards commodity and equity derivatives within the Basel framework.

¹ BCBS & IOSCO Joint Document – BCBS 261 – Margin requirements for non-centrally cleared derivatives

² We acknowledge differences in the relationships amongst other products as well, however we viewed the commodity to interest rate difference as the most egregious.

Asset Class	NIMM Supervisory Factor (No Margin)	BCBS 261 Margin Schedule For Non-Cleared
Interest Rate Derivatives	0.5% (1 year)	1.0% (1yr)
Foreign Exchange Derivatives	5%	6%
Equity Derivatives, Single Names	32%	15%
Equity Derivatives, Index	20%	15%
Commodity Derivatives - Energy (Electricity)	40%	15%
Commodity Derivatives - Energy (Oil/Gas)	15%	15%
Commodity Derivatives - Metals	15%	15%
Commodity Derivatives - Agricultural	15%	15%
Commodity Derivatives - Other	15%	15%

Correlations by Asset Classes in the NIMM text

We have also reviewed the correlation factors under the NIMM approach and compared them to the margin credits and correlations observed by CME. CME bases its correlations and credits on four years of observed data for each derivative pair or basket. While we realize that the correlation factors in the NIMM approach are not applied in the same manner, the correlation components recommended under NIMM appear too low for most commodity derivatives asset classes. Further, they simply do not exist under NIMM for foreign exchange derivatives despite being easily observable in the data.³

CME publishes correlations and margin credits on its public website⁴ for general use by market participants in derivatives strategies. We have summarized our observed correlations below, aligning our experience to the correlation factors advised in the NIMM text for certain commodities asset classes.

We ask the BCBS committee to use CME data as a reference point in calibrating the NIMM correlation factors for the product classes listed below and we would be happy to answer any questions should they arise.

Asset Class	NIMM Correlation	CME Observed Correlations
Commodity Derivatives - Agricultural	40%	45%
Commodity Derivatives - Energy - Oil / Gas	40%	80%
Commodity Derivatives - Metals	40%	61%

Absence of Netting Across Currencies

The netting approach and recognition of risk offsets in NIMM is a step forward from the approach taken in the Current Exposure Methodology. However, the NIMM approach ignores some key characteristics

³ We will elaborate on this issue in the next section of the letter.

⁴ <http://www.cmegroup.com/clearing/margins> - Search by "Inters/Intex/Supers" for correlation margin credits

and correlations between currencies within the interest rate derivatives and foreign exchange derivatives asset classes. For example, foreign exchange portfolios often include synthetic trades using multiple currency pairs (i.e. EUR/USD, USD/GBP, and GBP/EUR). CME Group allows margin credits towards these types of pairs based on observed correlations using four year look back periods. For example, a GBP/USD/EUR mix would generally carry a 40% margin credit. These correlations and margin credits are publicly available on our websites and are crucial to market participants. The same holds true in the interest rate swap market where participants often trade interest rate swaps across different currencies.

BCBS should allow partial offsets for currency pairs that share a common currency leg, similar to the proposed provision of partial offsets in interest rates across adjoining maturity buckets. We believe this would allow for a more accurate measurement of the exposures for foreign exchange and interest rate derivatives. At a minimum there should be an offset matrix among the most liquid currencies (i.e. G7 currencies), that are broadly recognized as meeting minimum liquidity thresholds.

Ignoring the correlations amongst these currencies in the NIMM approach could have wide implications depending on whether NIMM is applied to a broad range of banks. . For a small bank using a synthetic currency transaction to achieve lower costs of funds, NIMM's lack of offset would inflate their exposures leading to an unreasonably high capital charge. BCBS should refine the NIMM approach to allow currency offsets to avoid unfair treatment of smaller banks and the currency product class.

Maturity Differentiation for Interest Rate Products

The treatment of interest rate derivatives under the BCBS 254 represents a strong step forward from the prior Current Exposure Methodology and we applaud the Committee's recognition of the netting arrangements routinely employed across the book of a single counterparty. However, we are concerned about the use of a "floor" maturity of 1 year. This approach leads to an overestimation of risk for interest rate derivatives with a time horizon of less than one year such as 3-month Eurodollar futures contracts. It further inappropriately measures the risk of a 3 month to 6 month offsetting trade.

While we understand that BCBS has likely proposed this floor for simplicity's sake, it would be easy for any participants calculating a NIMM exposure to apply a formula that would account for a trade's remaining maturity based on a 365 day year. BCBS should remove the 1 year floor and allow fractions of a year to account for the variable risk within a one year horizon. We further note that during the 2008 financial crisis short term interest rate derivatives demonstrated the ability to move dramatically in a 12 month period. As NIMM currently stands, it would fail to account for these movements in calculating interest rate risk exposure. Using the approach suggested by CME would allow for a more granular, accurate and risk appropriate maturity scaling for interest rate derivatives notional exposures.

(II) Items for Clarification

Long Option Value Collateral Treatment

Non-linear instruments listed on an exchange generally follow one of two margin treatments, equity style or futures style.

The premium on an equity style instrument is paid by the buyer to the seller when the instrument is traded and the premium is exchanged during the clearinghouse's mark-to-market cycle. The premium then becomes the instrument's asset value to the buyer and the value is a credit to the initial margin requirement for the buyer's portfolio. Conversely, the premium becomes a debit to the initial margin requirement for the seller's portfolio. From that point on, the instrument is marked-to-market daily with increases in value crediting the buyer's initial margin requirement and decreases in value reducing the credit. Conversely, increases in value further increase the seller's initial margin requirement, while decreases in value reduce the initial margin requirement. The premium on a futures style instrument is paid on exercise or expiry, however the instrument is still marked-to-market daily and the change in value is debited or credited to the initial margin requirement in a similar manner to an equity style instrument.

Therefore, to the extent the value of a non-linear instrument serves as a form of collateral utilized to satisfy initial requirements for a portfolio, the value should be included in the NIMM text as a form of collateral. This was the approach allowed under the Current Exposure Method and it should carry over into NIMM.

Supervisory Factors for Centrally Cleared Derivatives

We note that in paragraph 96 of the BCBS 254 text, the table contains Supervisory Factors under both a "No Margin" and "Margin" approach. Under the QIS instructions, we have been told to use the "Margin" Supervisory Factors for the purpose of compiling our clearing member firm data.

We note that the "Margin" Supervisory Factors reflect a "Time Risk Horizon" (paragraph 81) adjustment of 10 days, whereas the adjustment for centrally cleared derivatives to be 5 days. Obviously, the move from 10 days to 5 days would lower the Supervisory Factors in the NIMM model. While we understand that the 10 day "Time Risk Horizon" is likely being used as part of the Joint Quantitative Impact Study for simplicity's sake, we believe the BCBS should clarify that the 5 day "Time Risk Horizon" will be used for the NIMM model for CCP's upon implementation. Further, we ask that CCP's using more frequent margining practices be allowed to use "Time Risk Horizon" adjustments reflective of the true margining practices at CCPs, whether 1 day, 2 days or otherwise.

(III) Response to specific BCBS 254 Consultation questions

Q1. Should the Basel Committee replace the CEM and SM with the NIMM in all areas of the capital framework? What are the benefits and drawbacks of using the NIMM in each of these areas?

CME will only opine on the improvements of NIMM over CEM in terms of reflecting risk exposures for derivatives. NIMM is a vast improvement over the current CEM methodology due to the recognition of netting and risk sensitivity, as well as the differentiation of asset classes. Incorporating the split between house and customer activity, along with netting within legally defined sets, is an improvement that is welcomed. CME can only hypothesize that these improvements in NIMM are likewise applicable for other uses, particularly the Leverage Ratio.

Q2. Is the proposed approach of retaining the general structure of the CEM with respect to replacement cost and the potential future exposure add-on appropriate? Is the division of the broad asset classes appropriate?

CME believes the inclusion of the alpha factor of 1.4 is inappropriate in the context of NIMM. Our understanding is that the 1.4 factor is traditionally applied to internal models to account for “model error”. NIMM by definition is not an internal model; it is a strict approach to quantifying potential future exposures. The alpha factor inclusion seems inappropriate given its core purpose.

The division of the broad asset classes is appropriate and allows for better recognition of risk sensitivity and netting.

Q4. Does the above approach reflect the replacement cost of margined transactions? Are there any other collateral mechanics that the Basel Committee should consider?

The Committee should consider the collateral mechanics of non-linear products as mentioned above in *‘Long Option Value Collateral Treatment’*. For the calculation of replacement cost, the unsettled mark-to-market on non-linear instruments should be reflected in ‘current market value’ and the collateralized value should be reflected in the ‘net collateral’ amount.

The Committee should also carefully consider the implications of the bankruptcy remoteness of cash. CME is currently conducting bankruptcy remoteness analysis for initial margin, but the bankruptcy remoteness of cash due is currently in question due to its fungibility. An alternative to the current approach is to treat cash separately throughout the NIMM replacement cost calculations.

Q5. Of the options under consideration for recognising offset across hedging sets, which treatment is preferred? What number of maturity buckets is appropriate to consider?

CME believes that the more appropriate risk management approach is to allow for partial offsets across maturity buckets for interest rate derivatives to ensure an appropriate level of risk sensitivity is achieved by NIMM. This would also help alleviate the disparity of treatment for positions with maturities at either end of the maturity buckets relative to positions within a maturity bucket (i.e. a position with a maturity

of 4.5 years and a position with a maturity of 5 years as compared to a position with 4.5 years and a position with 5.5 years).

CME believes that the three maturity buckets is an appropriate approach given the BCBS preference for simplicity.

Q6. Is the proposed approach of using a different methodology for determining the add-on for each asset class appropriate? Is each proposed add-on methodology for each asset class effective at capturing the main risk driver of that asset class?

CME would like to repeat its belief that a fixed supervisory delta for non-linear instruments is not an appropriate way for determining the add-on for products across the NIMM asset classes. Please see our analysis above for further information.

Additionally, CME believes that foreign currency and interest rate derivatives sharing a common leg should receive partial offsets in the NIMM methodology. While this represents an additional step in the NIMM calculation, it would allow for critical improvements to the accuracy of NIMM's measure of potential future exposures in these asset classes.

Also, CME acknowledges that while commodity derivatives carry a higher volatility and thus higher potential future exposure than interest rate derivatives, the volatility differential is not a factor of 30. BCBS should publish their study that quantifies this differential which could be used by market participants to better understand the relationship. As evidenced by the 15-1 relationship applied in BCBS 261 between commodity and interest rate derivatives, there is still some confusion about this relationship. The BCBS should remediate this conflict and apply a consistent relationship across its various proposals.

Q7. Are the proposed minimum time risk horizons for each transaction category (unmargined, non-centrally cleared, centrally cleared) appropriate? Should the Basel Committee consider factors other than the IMM for determining the appropriate time risk horizon for the NIMM (eg harmonising with other international or national legislation)?

CME believes the time risk horizon factor for centrally cleared derivatives should not be fixed at 5 days and should reflect the true margining practices employed at each clearing house. This standard does not account for the long-established and demonstrated liquidity characteristics of certain exchange traded derivatives. Uniform treatment of all cleared derivatives may reduce incentives for market participants to use safer, more standardized, liquid and transparent products.

Additionally, we believe that the NIMM consultation as currently proposed fails to take into account the significant differentiation between margined trades that are cleared and margined trades that are uncleared as demonstrated in the supervisory factor summary of proposed add-ons since there are only two different levels of supervisory factors, 'no margin' and 'margin'.

Q8. Do the suggested formula and 5% floor appropriately recognise the benefits of overcollateralisation?

We believe that the 5% floor represents an arbitrary figure and should be removed for cleared transactions. The Basel Committee should allow any amount of collateral to offset directly the positive replacement cost due to the significant mitigation of counterparty credit risk by central clearing. This would allow for a more accurate representation of the exposure for derivatives with lower current market values that still require collateral due to high volatility.

Q10. Are there any risk factors that should be included in their own category or accounted for in another manner?

CME reiterates its position that a fixed Supervisory Delta's for non-linear trades of +/- 0.5 does not appropriately reflect the risk or exposures associated with non-linear derivatives and that market based deltas should be used where available.



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.

Taken together, BCBS 251, 253, and 254 as well as other BCBS proposed standards such as single counterparty limits to QCCP exposures, will result in significantly higher capital costs and more restrictive limits for central clearing. Such an outcome would be counter to the G20 and the BCBS commitments in favor of clearing of standardized OTC products and may result in market participants avoiding central clearing by developing economically equivalent products that are not subject to the clearing mandate. The BCBS should heed the lessons learned during the 2008 financial crisis and revise its proposals to ensure that they do not contradict the G20 mandate or the goals of the BCBS itself.

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 +1 312 930-3156 and Kim.Taylor@cmegroup.com or Tim Doar, Managing Director and Chief Risk Officer at +1 312 930-3162 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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A handwritten signature in blue ink, appearing to read "Lee Betsill", with a long, flowing horizontal line extending to the right.

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