



March 27, 2015

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

Re: Basel Committee on Banking Supervision Consultative Documents:

- **BCBS 306 - Capital floors: the design of a framework based on standardised approaches**
- **BCBS 307 - Revisions to the standardised approach for credit risk**

Dear Committee Members:

CME Group Inc. ("CME Group")¹, on behalf of Chicago Mercantile Exchange Inc.'s Clearing Division ("CME Clearing") and CME Clearing Europe Limited ("CME Clearing Europe"), appreciates the opportunity to comment on the Basel Committee for Banking Supervision's ("BCBS") consultation papers, Capital floors: the design of a framework based on standardised approaches ("BCBS 306") and Revisions to the standardised approach for credit risk ("BCBS 307"). 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. Both of these entities adhere to the locally implemented version of the Committee on Payments and Market Infrastructures² ("CPMI") and International Organization of Securities Commissions ("IOSCO") Principles for Financial Market Infrastructures³ ("PFMI"), a requirement to be considered a Qualifying Central Counterparty ("QCCP") under the Basel framework⁴. In the US, the PFMI's were locally implemented in a manner consistent

¹ CME Group is the parent company of four Designated Contract Markets ("DCMs"): the Chicago Mercantile Exchange ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), 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 Clearing Europe is regulated and supervised by the Bank of England as an authorized central counterparty under the European Market Infrastructure Regulations ("EMIR"). CME Clearing is registered with the CFTC as a derivatives clearing organization ("DCO"), is one of the largest central counterparty ("CCP") clearing services in the world, and has been deemed a systemically important financial market utility by the Financial Stability Oversight Council and is in the process of becoming recognized under EMIR.

² The Committee on Payment and Settlement Systems ("CPSS") was renamed as CPMI on September 1, 2014.

³ Committee on Payment and Settlement Systems & Technical Committee of the International Organization of Securities Commissions (CPSS-IOSCO), Principles for financial market infrastructures (April 2012)

⁴ Basel Committee on Banking Supervision: Capital requirements for bank exposures to central counterparties, BCBS 282 (April 2014)



with the global standards by the Commodity Futures Trading Commission (“CFTC”) through the Derivatives Clearing Organizations and International Standards; Final Rule⁵, and in the European Union through the European Market Infrastructure Regulation (“EMIR”).

CME Group supports the efforts of the 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 to reduce systemic risk.

In the consultative documents, there are several proposals that could have varying levels of impacts on the marketplace where CME operates, and our comments are provided in hopes that they will benefit the BCBS while determining their final policy recommendations.

BCBS 306 - Capital floors: the design of a framework based on standardised approaches

Q3. Do you have any other comments regarding the design of the capital floor?

CME does not disagree with the concept or proposed design of the capital floor; however we believe that the calibration of the capital floor must account for the Basel III Leverage Ratio Framework⁶ as forming another capital backstop and avoid the adverse consequences that could potentially be experienced by commercial end users if the design, like the Basel III Leverage Ratio, does not account for specific market dynamics and regulatory requirements. In short, the Capital Floor and Leverage Ratio cannot be viewed separately, and should, in tandem, account for both the G-20 commitments to central clearing and the impacts of capital constraints on bank decision-making, particularly where incorrect capital treatment could drive banks towards riskier areas of their business.

In the second consultation, BCBS 307, the capital floor for OTC derivatives relies on the BCBS standardised approach for measuring counterparty credit risk exposures⁷. CME does not disagree with the proposed approach for the capital floor design as it takes into account the exposure reducing effect of appropriately segregated client initial margin collateral similar to how the existing interim capital requirements for centrally cleared derivatives already do⁸; however, CME would like to highlight the incongruence of this approach with the current calibration of centrally cleared OTC derivatives under the Basel III Leverage Ratio. Allow us to expand on the current issue centrally cleared market participants face under the Basel III Leverage Ratio:

The Basel III Leverage Ratio is calculated by dividing a firm’s capital measure, typically Tier One capital, by its leverage exposures, a combination of the banks’ balance sheet and other

⁵ <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-27849a.pdf>

⁶ Basel Committee on Banking Supervision: Basel III leverage ratio framework and disclosure requirements, BCBS 270 (January 2014)

⁷ Basel Committee on Banking Supervision: The standardised approach for measuring counterparty credit risk exposures, BCBS 279 (March 2014)

⁸ Basel Committee on Banking Supervision: Capital requirements for bank exposures to central counterparties, BCBS 227 (July 2012)

exposures. The leverage exposure measurement treats derivatives exposures for both cleared and uncleared derivatives the same utilizing a blunt calculation tool known as the Current Exposure Measure (“CEM”). As adopted, it does not allow initial margin collected from clients to offset derivatives exposures even where such initial margin is segregated from the clearing members assets and unavailable to be used for leverage. Further, any collateral that banks collect from clients to meet initial margin requirements that sit on balance sheet (e.g. cash) is added to the result of the CEM calculation, resulting in collateral counterintuitively increasing rather than decreasing leverage exposure. Any model that creates incentives for clearing members to reduce the use of client segregated initial margin to avoid increasing capital costs is inherently flawed.

The treatment of initial margin under the current Basel III Leverage Ratio has its roots based on of the treatment of collateral in the uncleared derivatives market. While we do not speak to the wisdom of how initial margin is used and re-used in the uncleared market, this treatment directly contradicts the limitations placed on collateral in the centrally cleared environment. For example, under the Commodity Exchange Act and CFTC Regulations in the United States, clearing members may not use customer collateral to secure or extend credit for any other person and the majority of this collateral is actually passed through to the CCP. In the European Union, the EMIR regime has similar strict requirements for client collateral that is passed on to CCP’s. Perversely, the current treatment of initial margin under the leverage ratio explicitly penalizes firms for collecting initial margin to mitigate exposures, conflicts with other Basel III standards and best practices in risk management and undermines the G-20 commitments to central clearing.⁹

Another consequence of the current Leverage Ratio structure will be increased systemic risk for cleared markets as it discourages participation by bank affiliated clearing members in a CCP’s default management process. In the event of a clearing member default, CCPs seek to port non-defaulting clients of the clearing member to non-defaulting clearing members. Given the current constraints placed on the capacity of bank affiliated clearing members that clear client exposures, there will likely be little to no capacity remaining at bank affiliated clearing members to take on the non-defaulting clients in the event of a fellow clearing member default.

In addition to the market impacts of the Leverage Ratio treatment of appropriately segregated client initial margin collateral, firms are forced to hold multiples of Tier 1 capital under the Basel III Leverage Ratio relative to the amount of capital required under the risk based Basel III capital requirements for their centrally cleared derivative exposures. This will ultimately reduce the impact and effectiveness of the proposed Capital Floor in regards to centrally cleared derivatives by ensuring that the Leverage Ratio is always the binding constraint.

⁹ Basel Committee on Banking Supervision: Capital requirements for bank exposures to central counterparties, BCBS 282 (April 2014) (“If a clearing member collects collateral from a client for client cleared trades and this collateral is passed on to the CCP, the clearing member may recognise this collateral for both the CCP-clearing member leg and the clearing member-client leg of the client cleared trade.”)



Recommendation

CME has already witnessed multiple clearing members cease providing clients with access to the centrally cleared derivatives markets because of this onerous and incorrect treatment of client segregated collateral under the Basel III Leverage Ratio and are very concerned that more clearing members will follow. Considering the demand for centrally cleared derivatives and the already limited availability of client clearing, we are very concerned that the real economy will suffer if the reduction in access to central clearing accelerates. CME asks the BCBS committee responsible for the calibration of the Capital Floor design consider the impacts of the Basel III Leverage Ratio during their calibration process to ensure that the capital floors avoid similar inappropriate results and recommends that the Basel III Leverage Ratio Working Group reconsider the treatment of appropriately segregated client initial margin collateral under the leverage exposures calculation. Capital floors and backstops are essential to a stable financial market but should not be designed in a manner that undermines the G-20 commitments or negatively impacts the real economy that the financial markets are designed to serve.

BCBS 307 - Revisions to the standardised approach for credit risk

Q1. What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation?

CME regularly assesses the counterparty credit strength of many of the banks that are covered by the Basel framework. CME believes that valuable information may be gleaned from a credit risk monitoring perspective in evaluating the requirements of the CET1 ratio, the Tier 1 Ratio, and the Leverage Ratio as they are all different measures of capital. However, CME would like to repeat that the current inappropriate treatment of appropriately segregated client initial margin collateral for centrally cleared derivatives under the Basel III Leverage Ratio undermines the accuracy of the Basel III Leverage Ratio as a true measure of bank leverage, and increases the likelihood that it will be the binding constraint in all scenarios where segregated initial margin is accepted from clients to offset centrally cleared exposures. As noted above, appropriate client segregated collateral passed from Banks to CCP's simply is not exposure additive for a bank and can only be used to offset or reduce the amount of leverage exposures the bank maintains. CME asks this BCBS committee to recommend to the Basel III Leverage Ratio Working Group to reconsider their treatment of appropriately segregated client initial margin collateral under the leverage exposures calculation.

Definition of "Core Market Participants"

CME has noted that the BCBS has included QCCPs in the definition of "core market participants" and agrees with this approach. CME believes that the requirement for QCCPs to adhere to the locally implemented regulations that are globally consistent with the CPMI-IOSCO PFMI's, which is true in the United States, European Union, and other global jurisdictions, appropriately gives them the right to, and benefits of, this designation under the proposed rules in a manner consistent with other regulated entities that play key roles in the financial markets. QCCPs provide important benefits to the broader



economy and help support the important policy objective of encouraging market participants to take advantage of the risk mitigation and price transparency benefits of central clearing.

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 Sunil Cutinho, President, CME Clearing at +1 312 634-1592 or Sunil.Cutinho@cmegroup.com.

Sincerely,

A handwritten signature in blue ink, appearing to read "Sunil Cutinho".

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