

VIA ELECTRONIC SUBMISSION

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

Re: Consultative Document: Revisions to the Basel III leverage ratio framework

CME Group Inc.¹ on behalf of CME Inc. and CME Clearing Europe, together (“CME Group”), appreciates the opportunity to comment on the Basel Committee on Banking Supervision’s (“BCBS”) consultative document; Revisions to the Basel III leverage ratio framework. CME Inc.’s clearing house division (“CME Clearing”) and CME Clearing Europe together offer clearing and settlement services for exchange-traded and over-the-counter (“OTC”) derivatives. CME Clearing Europe is regulated and supervised by the Bank of England as an authorized central counterparty (“CCP”) under the European Market Infrastructure Regulations (“EMIR”). CME Clearing is registered with the Commodity Futures Trading Commission (“CFTC”) as a derivatives clearing organization (“DCO”), has been deemed a systemically important financial market utility by the Financial Stability Oversight Council (“FSOC”), and is a recognized third-country CCP under EMIR.

CME Group participated in the comment period process during the BCBS June 2013 consultative document on the revised leverage ratio standard², and we are happy to contribute again to this consultative document of proposed revisions to the Basel III leverage ratio framework. CME Group agrees with the goals of the leverage ratio framework to restrict the build-up of leverage in the banking sector and to reinforce the risk-based capital requirements with a simple, non-risk-based backstop measure.

CME Group is greatly concerned that the goals of the G-20³ are undermined by the Basel III leverage ratio framework both as currently constructed and with the proposed revisions contained in the April 2016 consultative document. CME Group believes that the issues with the proposed Basel III leverage ratio framework for banks providing clients access to derivatives clearing services stems from the fact that the treatment of client initial margin in the non-centrally cleared derivatives market was

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.

² Basel Committee on Banking Supervision: Revised Basel III leverage ratio framework and disclosure requirements - consultative document; <http://www.bis.org/publ/bcbs251.htm>

³ G20 Leaders Statement: The Pittsburgh Summit (September 24-25 2009); available at <http://www.g20.utoronto.ca/2009/2009communique0925.html>



inappropriately used as a template for the treatment of client initial margin for centrally cleared derivatives. Not only does this approach ignore the significant differences between the centrally cleared and non-centrally cleared derivatives markets, it has serious consequences for financial stability and the Main Street businesses that are the bedrock of a well-functioning economy. The proposed Basel III leverage ratio framework fails to recognize the over \$300B in customer segregated collateral that is held at CCP's globally to secure the derivatives positions of end users. This \$300B figure is based on the aggregated client segregated initial margin amounts reported globally by CCP's in their Committee on Payments and Market Infrastructures ("CPMI") and Board of the International Organization of Securities Commissions ("IOSCO") Public Quantitative Disclosures⁴ as of December 31st, 2015. Importantly, this \$300B figure represents the client segregated initial margin amounts as reported by CCP's, and is therefore a conservative estimate of the total amount of customer segregated initial margin amounts in the central clearing universe because it ignores the excess customer segregated deposits that are held by the bank affiliated clearing members whom are subject to the Basel III leverage ratio framework.

CME Group supports the comments made by the World Federation of Exchanges ("WFE") and the Global Association of Central Counterparties ("CCP12") in their responses to this consultative document, and is filing this separate comment letter to further highlight areas of concern to CME Group:

1. Central clearing services provided by banks to customers must be calculated under the Basel III leverage ratio framework in a manner which recognizes the exposure reducing effects of customer segregated collateral collected by banks in order to provide these central clearing services to their customers.
2. At a minimum, and in order to retain consistency with other areas of the existing Basel III leverage ratio framework, when sizing exposures for customer clearing services, banks must be allowed to reduce their client clearing derivatives exposures by the customer segregated collateral that is posted and held by CCP's and is therefore outside the ownership and control of the banks.
3. Lack of recognition of the over \$300B in customer segregated collateral at CCP's globally introduces systemic risks in the global financial markets. This is due to the difficulties bank affiliated clearing members will experience in accepting the fully margined and solvent customers of a defaulting clearing member during a period of financial stress.
4. Ultimately it is the end users of derivatives central clearing services who will bear the consequences of the continued failure of the Basel III leverage ratio framework to recognize the exposure reducing effects of their appropriately segregated collateral; reducing their access to these services and negatively impacting their ability to hedge their risks in the most liquid and transparent markets and thus leading to price instability for retail consumers.

⁴ Committee on Payments and Market Infrastructures & Board of the International Organization of Securities Commissions: Public quantitative disclosure standards for central counterparties;
<http://www.bis.org/cpmi/publ/d125.pdf>



Customer Segregated Collateral

CCP's robust risk management practices that serve as a model for the post-financial crisis markets are based on the standards set out under the CPMI & IOSCO Principles for Financial Market Infrastructures ("PFMI")⁵. One example is PFMI Principle 14 which requires the strict segregation of customer collateral as follows:

Principle 14: Segregation and portability

A CCP should have rules and procedures that enable the segregation and portability of positions of a participant's customers and the collateral provided to the CCP with respect to those positions.

For background, a CCP acts as the buyer to every seller and seller to every buyer for the contracts cleared on its financial markets. CCP's maintain direct relationships with clearing members to effectuate this process, with those clearing members often being banks or affiliates of banks subject to the Basel III leverage ratio framework. These clearing members centrally clear both their own proprietary derivatives and they also provide access to central clearing services for customers who do not maintain this direct relationship at the CCP under the segregated regimes that have been tailored to their local markets, and which are based on this fundamental CPMI-IOSCO Principle.

Clearing services for clients and end users are important to the global financial markets because they allow these market participants who are unable to become direct CCP clearing members to benefit from the counterparty risk mitigation afforded by a CCP. When performing this service for clients, clearing members are required to segregate the positions and collateral of their customers from that of their own proprietary positions and collateral under local segregation regimes consistent with PFMI Principle 14. In the United States, under CFTC rules, a clearing member must separately account for, and segregate as belonging to the end-user, all money, securities and property it receives from an end-user as margin⁶. Similarly, in the United Kingdom, clearing firms segregate the margin of clients that are provided money protection under the Client Asset Sourcebook ("CASS") regime⁷.

The important economic reality of this completely segregated and application of collected customer funds for their centrally cleared derivatives is that the funds exist for the sole purpose to offset the potential future exposures arising from those customer's derivatives positions at a CCP. This economic reality is reflected in the risk-based area of the Basel III capital framework, and the proposed Basel III leverage ratio framework to ignore this economic reality by way of introduction of a modified version of

⁵ Committee on Payment and Settlement Systems & Technical Committee of the International Organization of Securities Commissions: Principles for financial market infrastructures; <http://www.bis.org/cpmi/publ/d101a.pdf>

⁶ See 17 C.F.R. §§ 1.20-1.30; 17 C.F.R. §§ 22.2-22.7; see also CFTC Chairman Timothy Massad, Testimony before the U.S. House Committee on Agriculture (Feb. 12, 2015).

⁷ See CASS 7.3.1R and CASS 7.4.1R.



the Standardized approach for measuring counterparty credit risk exposures (“SA-CCR”)⁸ will only act to further frustrate the access to central clearing services by end user market participants.

While the move under the proposed revisions to the Basel III leverage ratio framework to the new SA-CCR method with an accompanying Margin Period of Risk (“MPOR”) of five days is a move in the right direction, it is by no means a solution to the issues facing the derivatives central clearing industry. Whether under the historic derivatives sizing method, the Current Exposure Method (“CEM”), a sizing methodology with a number of shortcomings, or the new modified SA-CCR method, both these proposed methods fall short of reflecting the economic exposures and leverage of a bank when providing central clearing services to their customers. Unfortunately, this latest proposal continues to ignore the market structure for centrally cleared derivatives by failing to provide an offset for appropriately segregated customer collateral. The continued failure to distinguish the centrally cleared derivatives market structure from that of the legacy non-centrally cleared derivatives market will have serious consequences for financial stability and end users who depend on these markets to hedge their business risks.

In order to enhance financial stability and protect access to central clearing services for end users, the Basel III leverage ratio framework must allow for appropriately segregated customer collateral to reduce the exposures for banks when calculating their Basel III leverage ratio requirements.

Customer Segregated Collateral Held at CCP’s

If the BCBS declines to recognize all customer segregated collateral as offsetting of derivatives exposures for providing client clearing services, it should, at a minimum, provide such recognition of the customer segregated collateral held at a CCP. This collateral is segregated and designed to cover the exposures of clients while also being outside the control of the clearing member. Clearing members will pass a substantial portion of their segregated customer collateral through to the CCP where the client positions have been placed in order to secure those derivative trades’ potential future exposures at the CCP. CCP’s are similarly limited in their use of customer segregated collateral and have ultimate control to ensure that it is used for the sole purpose of offsetting client exposures.



⁸ Basel Committee on Banking Supervision: The standardised approach for measuring counterparty credit risk exposures; <http://www.bis.org/publ/bcbs279.pdf>



By passing both the customer collateral and derivatives trades through to the CCP, clearing members providing these clearing services to clients at derivatives CCP's are acting as an agent for the customer trades they bring to the CCP, consistent with the relationship under the existing Basel III leverage ratio framework for securities financing transactions ("SFT"):

35. Bank acting as agent: a bank acting as agent in an SFT generally provides an indemnity or guarantee to only one of the two parties involved, and only for the difference between the value of the security or cash its customer has lent and the value of collateral the borrower has provided. In this situation, the bank is exposed to the counterparty of its customer for the difference in values rather than to the full exposure to the underlying security or cash of the transaction (as is the case where the bank is one of the principals in the transaction). Where the bank does not own/control the underlying cash or security resource, that resource cannot be leveraged by the bank.

CME Group stresses this relationship in our comments to the BCBS because the BCBS has already chosen to appropriately account for this agent relationship in the SFT framework by allowing the bank acting as an agent to recognize their exposure for a customer's SFT as the difference in value between the security or cash its customer has lent and the value of collateral the borrower has provided. The BCBS has seen fit to prevent the accurate reflection of this relationship for derivatives clearing services where banks are acting on behalf of their customers.

Plainly speaking, when the bank is acting on behalf of their customers in an SFT, the bank is able to recognize the net exposure between the two amounts rather than the full value of any single leg of the SFT exposure. The ability for the bank to net the two legs of the SFT resides on whether or not the bank owns or controls the underlying cash or security resource. If the bank does not own or control that resource, in the BCBS's own words, that resource cannot be leverage for the bank. As stated above, this relationship is nearly identical in practice to the relationships clearing members serve for their customers at derivatives CCP's which operate under the CPMI & IOSCO PFMI's.

It is for these reasons that CME believes, at a minimum, that derivatives clearing services provided for customers at a Qualifying Central Counterparty ("QCCP") per the BCBS definition⁹, must be allowed to be sized under the Basel III leverage ratio framework recognizing the exposure reduction effect of the customer initial margin held at a CCP, which is outside the ownership and control of the clearing member.

Systemic Risks in the Global Financial Markets

Increased systemic risk in the centrally cleared derivatives market will be the result of the Basel III leverage ratio frameworks continued failure to recognize the role and use of segregated customer margin for centrally cleared derivatives. The current Basel III leverage ratio framework based on the CEM approach without recognition of segregated customer margin, and the proposed revised approach allowing the use of a newly designed modified SA-CCR, will increase systemic risk through the concentration of customer clearing at a reduced number of clearing members. In turn, a reduced

⁹ Basel Committee on Banking Supervision: Capital requirements for bank exposures to central counterparties; <http://www.bis.org/publ/bcbs282.pdf>



number of clearing members will lessen the probability of the successful porting of the solvent customers of a defaulting clearing member to a CCP.

The clearing members who remain may not have the capacity to take on additional client clearing to facilitate the porting of a solvent group of customers of a defaulting clearing member during a time of crisis, undermining another aspect of the CPMI and IOSCO Principle 14, Segregation and Portability. This is due to the binding Basel III leverage ratio constraint on their balance sheets due to the lack of recognition of appropriately segregated customer margin collateral, despite the fact that the accepting clearing member would receive the segregated customer margin deposits at the CCP to offset their exposures. Ultimately this could have severe consequences on the real economy during a time of significant financial stress because CCP's would be forced to liquidate the fully margined positions of the defaulted clearing members' customers due to the inability of any other clearing member to accept these new customers as a result of their Basel III leverage ratio capital restraints.

In effect, banks and bank affiliates who would otherwise bid on a portfolio of CCP margined customer accounts due to the available segregated customer margin to offset exposure would instead decline to bid for fear of the punitive capital requirements under the Basel III leverage ratio. Balancing Basel III leverage ratio costs and the business benefit of taking on new customers would be a difficult decision for any bank or bank affiliate and would result in additional pressure for forced liquidation during a crisis, adding pressure to the markets and increasing overall systemic risk.

Implications on the Real Economy

Today, many bank-affiliated clearing firms are evaluating whether to cease offering client clearing services, and the proposed revisions will only continue this debate due to the significant cost impact of the Basel III leverage ratio on providing client clearing services. This decision will ultimately increase risk at these clearing member entities since they exited the low risk and highly regulated business of client clearing services, and also in the global financial markets more generally by concentrating customer clearing services into fewer entities.

Furthermore, the costs of the leverage ratio to clearing members will likely narrow the range of clients with central clearing access, subjecting those firms to increased risk exposures while also decreasing diversification in central clearing, which could result in reduced liquidity and increased concentration risk in the market. Additionally, the Basel III leverage ratio will greatly restrict clearing members' ability to provide clearing services to large clients, such as pension funds, asset managers, insurance companies, and Government Sponsored Entities who use derivatives to hedge their exposures and are subject to OTC clearing mandates due to their sheer size. CME Group directs the BCBS to the recent efforts of the Asset Management Group ("AMG") of the Securities Industry and Financial Markets Association ("SIFMA") for observable examples of this trend¹⁰. Over 40% of respondents to the SIFMA AMG survey reported increased fees for simply posting cash initial margin for their exchange traded and interest rate swap positions, perversely in contrast to the goals of encouraging banks to collateralize their client exposures with the most liquid form of collateral.

The outcomes associated with the implementation of the Basel III leverage ratio in its current form stand in stark contrast to the explicit goals of the G20 commitment to promote the central clearing of

¹⁰ [SIFMA letter to Basel Committee on Banking Supervision dated February 1st 2016](#)



standardized, liquid swaps. While some might argue that other, non-bank-affiliated clearing members who are not subject to the Basel III leverage ratio could support the client clearing business, these entities do not have the access to capital to support the business. Since instruments such as wheat futures are subject to the greatest penalties under the leverage ratio as currently constructed, the largest impact will be to clients who rely on derivatives the most to hedge their business exposures in the liquid and transparent centrally cleared markets.

Quantitative Data

In addition to our largely qualitative remarks above, CME Group is submitting additional confidential information to the BCBS which we believe will further highlight the need for a Basel III leverage ratio framework for client clearing services which appropriately recognizes the exposure reducing effect of appropriately segregated customer margin.

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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