CME Group

January 16, 2019

VIA ELECTRONIC SUBMISSION

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

Re: Consultative Document: Leverage ratio treatment of client cleared derivatives

CME Group Inc. ("CME Group")[1] is the parent of the Chicago Mercantile Exchange Inc. ("CME"). CME is registered with the Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization ("DCO") and is one of the largest central counterparty ("CCP") clearing services in the world. CME's clearing house division ("CME Clearing") offers clearing and settlement services for exchange-traded futures and options on futures contracts, as well as over-the-counter ("OTC") derivatives transactions, including interest rate swaps ("IRS") products. On July 18, 2012, the Financial Stability Oversight Council designated CME as a systemically important financial market utility ("designated FMU") under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

CME Group appreciates the opportunity to comment on the Basel Committee on Banking Supervision's ("BCBS") consultative document on the *Leverage ratio treatment of client cleared derivatives* ("the Consultation").[2] CME Group previously participated in the request for comments with respect to the leverage ratio in response to the consultative documents published in June 2013[3] and April 2016.[4] Consistent with our responses to previous consultations, we applaud BCBS for proposing revisions to the treatment of client cleared derivatives in the leverage ratio. While we understand the need for BCBS to make an informed, evidence-based decision prior to revising the leverage ratio, we are confident that

[1] As a leading and most diverse derivatives marketplace, CME Group enables clients to trade futures, cash and OTC markets, optimize portfolios, and analyze data - empowering market participants worldwide to efficiently manage risk and capture opportunities. CME Group exchanges offer the widest range of global benchmark products across all major asset classes based on interest rates, equity indexes, foreign exchange, energy, agricultural products and metals. The company offers futures trading through the CME Globex platform, fixed income trading via BrokerTec and foreign exchange trading on the EBS platform. In addition, it operates one of the world's leading central counterparty clearing providers, CME Clearing. With a range of pre- and post-trade products and services underpinning the entire lifecycle of a trade, CME Group also offers optimization services through TriOptima, and trade processing and reconciliation services through Traiana.

[2] Basel Committee on Banking Supervision, Consultative Document, *Leverage ratio treatment of client cleared derivatives* [hereafter *the Consultation*] (Oct. 2018).

[3] Basel Committee on Banking Supervision, Consultative Document, *Revised Basel III leverage ratio framework and disclosure requirements* (June 2013).

[4] Basel Committee on Banking Supervision, Consultative Document, *Revised Basel III leverage ratio framework and disclosure requirements* (Apr. 2016).

market stakeholders and policy-makers have provided clear and convincing evidence that revisions are necessary to address the shortcomings of the leverage ratio with respect to centrally cleared derivatives.

CME Group continues to be concerned with the current construction of the Basel III leverage ratio framework (i.e., Option 1 under the Consultation) where there is no provision for bank and bank-affiliated clearing members to offset their leverage exposure for client cleared derivatives with segregated client initial margin. The current leverage ratio formulation creates systemic risk concerns due to the inability to recognize the exposure reducing nature of segregated client initial margin. Since the introduction of the Basel III leverage ratio, centrally cleared derivatives markets have observed an increased concentration in client clearing. This concentration coupled with the implications of the current leverage ratio for managing a market stress event serves to unnecessarily increase systemic risk, in part by undermining the likelihood of successful porting of the clients of a defaulted clearing member.

Adopting one of the proposed revisions to the leverage ratio under the Consultation aligns with the G20 Leaders' policy objectives to promote the use central clearing while ensuring that the resilience of the banking system is strengthened by preventing excessive build-up of leverage.[5] In particular, the proposed revisions to the current leverage ratio in the Consultation (i.e., Options 2 and 3 under the Consultation) would lessen the capital constraints being imposed on the provision of client clearing services, which reduces systemic risk, without introducing further leverage into the system. The leverage ratio was not designed to limit the allocation of capital to risk-reducing services, such as client clearing, and was instead, intended to act as a backstop to risk-based capital requirements. Unfortunately, the fact that the current leverage ratio design originates from uncleared OTC market convention has resulted in the perverse outcome where banks are incentivized to allocate capital to business lines that have higher risk. Further, our analysis indicates that allowing segregated client initial margin to reduce leverage exposure in centrally cleared derivatives markets would not allow for the build-up of excessive leverage as it results in a nominal change to tier 1 capital requirements at the bank holding company level.[6]

It is our understanding of the Consultation that Option 2 permits cash and non-cash client initial margin to offset potential future exposure of client cleared derivatives and Option 3 allows cash and non-cash client initial margin and variation margin to offset replacement cost and potential future exposure for client cleared derivatives. CME Group supports both Options 2 and 3 to recognize the exposure reducing nature of segregated client initial margin for client cleared derivatives under the leverage ratio. However, we favor Option 3 since the inclusion of both initial margin and variation margin as offsets to leverage exposure more accurately reflect the exposure mitigation tools utilized in the market structure for centrally cleared derivatives.

Question 1. Is there concrete and robust empirical evidence that would warrant a revision to the leverage ratio treatment of client cleared derivatives?

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[5] G20 Leaders Statement, The Pittsburgh Summit (September 24-25, 2009), *available at* http://www.g20.utoronto.ca/2009/2009communique0925.html.

[6] Please refer to the analysis in response to the Consultation that CME Group submitted on a confidential basis as Appendix I.

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Yes, CME Group believes there is concrete and robust empirical evidence that would warrant a revision to the leverage ratio treatment of client cleared derivatives. We believe analysis performed by market stakeholders, including international standard setters and local regulators, has provided clear and convincing evidence that the leverage ratio should be revised to recognize the market structure for centrally cleared derivatives and the failure to do so has had negative impacts on centrally cleared derivatives markets and, thus systemic risk.[7] To complement this work, we have prepared quantitative analysis submitted on a confidential basis for BCBS' review as Appendix I. We note that we are not alone in holding this view, as we have observed policy-makers begin work towards implementing changes to their local legislation and regulatory requirements to address the negative effects of a leverage ratio framework that fails to recognize the market structure for centrally cleared derivatives.[8]

Question 2. To what extent would the two potential revisions discussed in this consultative document adequately meet the G20 Leaders' policy objectives of strengthening the resilience of the banking system by preventing excessive leverage and promoting central clearing of standardized derivative contracts?

CME Group recognizes the need for BCBS to evaluate the G20 Leaders' policy objectives collectively and believes changes to the leverage ratio to recognize the market structure for client cleared derivatives are consistent with their objectives of strengthening the resilience of the banking system. It is critical to be cognizant that the impact of bank capital standards extend far beyond the banking industry and have widespread effects on the real economy.

The adoption of Option 2 or Option 3 of the Consultation would strengthen the resilience of the financial system by encouraging the use of the risk mitigation benefits of centrally cleared derivatives while continuing to prevent the build-up of excess leverage in the banking system. The application of either of

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[7] *See* Jonathon Acosta-Smith, Gerardo Ferrara & Francesc Rodriguez-Tous, *The impact of the leverage ratio on client clearing*, Staff Working Paper No. 735 (June 2018), *available at* https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2018/the-impact-of-the-leverage-ratio-on-client-clearing.pdf; Basel Committee on Banking Supervision, Committee on Payments and Market Infrastructures, Financial Stability Board, and International Organization of Securities Commission, final report, *Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms* (Nov. 2018); J. Christopher Giancarlo, Chairman Commodity Futures Trading Commission, Changing Swaps Trading Liquidity, Market Fragmentation and Regulatory Comity in Post-Reform Global Swaps Markets (May 10, 2017), *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22; Richard Haynes, Lihong McPhail & Haoxiang Zhu, *CFTC Policy Brief - Assessing the Impact of the Basel III Leverage Ratio on the Competitive Landscape of US Derivative Markets: Evidence from Options* (June 2018), *available at* https://www.cftc.gov/sites/default/files/About/Economic%20Analysis/oce_leverage_and_options.pdf; U.S. Department of Treasury, *A Financial System that Creates Economic Opportunities: Capital Markets* (Oct. 2017).

[8] H.R. 4659, 115th Cong. (2018); S. 3682, 115th Cong. (2018); Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012, COM (2016) 850.

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the two options would reflect the confidence G20 Leaders demonstrated in the market structure for client cleared derivatives, by accurately recognizing the fundamental role of client initial margin as a source of exposure mitigation, rather than leverage. The role of centrally cleared derivatives markets as reducing systemic risk and acting as a safe haven in times of market stress during the financial crisis drove the G20 Leaders' policy objective to promote the use of central clearing, including for clients. To date, the leverage ratio has undermined this objective.

As noted in the confidential data we submitted as Appendix I, the adoption of Option 3 would have a nominal impact on tier 1 capital requirements at the bank holding company level, though significant impacts on the ability of bank and bank-affiliated clearing members to offer client clearing, and in turn, would be consistent with the G20 Leaders' policy objective to prevent excessive leverage in the banking system. However, it is important to understand that many bank holding companies allocate capital based on the constraints at the business line or even trading desk level. Thus, the leverage ratio may be binding at a more granular level than the bank holding company level based on the bank's allocation decisions.[9] Given how bank holding companies allocate capital, it is critical that different capital requirements are appropriately capturing the true exposures of activities. Making low exposure, low return activities, such as client clearing services, inappropriately expensive will restrict the capital allocation to such activities, resulting in capital allocation to other activities which could increase risk in the overall financial system.

Market Structure for Centrally Cleared Derivatives

In the case of centrally cleared derivatives, the role of a clearing member providing client clearing services must be understood and accurately accounted for in the leverage ratio's design. Clearing members act as agents for their clients to the CCP and guarantee their clients' performance to the CCP, assuming payment obligations associated with a client default. Clearing members mitigate their potential future exposures to their clients through the collection of initial margin.

Under the U.S. regulatory regime enforced by the CFTC, a futures commission merchant ("FCM") (i.e., client clearing members for U.S. based derivatives markets) collects initial margin directly from its clients and such margin may only be used to offset the client exposure guaranteed by the FCM. Client initial margin resources are held in a segregated account separate from the FCM's own funds and the vast majority of such resources are passed on to the CCP, where segregation is maintained. Our analysis indicates that in excess of 80% of client initial margin is passed from the FCM to the CCP, where it remains outside the ownership and moves outside the control of the FCM. We note that initial margin deposited with the CCP is held in a manner consistent with the requirements for collateral to offset securities financing transaction exposures under paragraph 53 of BCBS 424.[10]

Systemic Risk Implications of the Current Leverage Ratio

The reduced availability of client clearing services due to the current leverage ratio calibration has been widely publicized within the derivatives industry. Many clearing members have discontinued offering client clearing services since the implementation of the post-crisis financial regulatory reforms, as can be

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[9] *See* Basel Committee on Banking Supervision, Committee on Payments and Market Infrastructures, Financial Stability Board, and International Organization of Securities Commission, final report, *Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms* (Nov. 2018).

[10] Basel Committee on Banking Supervision, *Basel III: Finalising post-crisis reforms* (Dec. 2017).

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observed from the declining number of FCMs. The lack of availability of client clearing has made it challenging for end-users to rely on central clearing services to manage their risks. This can result in significant real economy impacts because end-users rely on clearing services to hedge their business risks, ultimately impacting the costs of consumer staples and asset management services relied upon by retirees, among other effects.

Further, the concentration of client clearing among clearing members presents systemic risk challenges. CME Group is concerned that the ongoing capital pressures resulting from the incorrect formulation of the leverage ratio may exacerbate market stress events by making it more challenging to port a large client portfolio. It is particularly unfortunate that systemic risk concerns have been an output of the post-crisis reforms that were designed with every intention of promoting the resilience of the financial system. Historically, CME Clearing and other U.S. DCOs have successfully ported the exchange-traded derivatives clients of a distressed clearing member, including during the financial crisis. The leverage ratio challenges these past successes. To date, the potential negative impact of the leverage ratio on client porting has not been tested, but that shouldn’t stop proactive reforms to address this regulatorily created risk.

For background, in the event of a clearing member default, a CCP generally seeks to port the non-defaulting clients of the defaulting clearing member. The lack of recognition of segregated client initial margin under the leverage ratio ignores the fact that this margin is essential to the non-defaulting clearing member’s decision to accept ported clients. In effect, the capital charge that the clearing member will incur because of its decision to accept ported clients has no correlation to the actual exposure the non-defaulting clearing member takes on as part of the default management process. The consequence of this is an increased likelihood of client portfolio liquidation in the event of a clearing member default because non-defaulting clearing members will be unable or unwilling to accept clients for porting. The unnecessary liquidation of these client portfolios will likely serve to elevate overall systemic risk by exacerbating volatility of an already stressed market. Such volatility could lead to further defaults and increased stress on the CCP and the financial system more generally, creating a domino effect. These systemic risk challenges could be easily avoided through the implementation of Option 3, or Option 2 in the alternative, which recognizes the market structure for centrally cleared derivatives.

Question 3. What are the potential forward-looking behavioral dynamics of the client clearing industry that could occur as a result of possible changes to the leverage ratio treatment of client cleared derivatives?

While we cannot speculate on how clearing members will support their client clearing services in the future, it is evident that the leverage ratio has had a negative impact on the provision of client clearing services by bank and bank-affiliated clearing members. This impact on client clearing has been

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consistently affirmed by market participants[11] and policy-makers.[12] The challenges are easily addressed by allowing for segregated client initial margin to offset leverage exposures and we believe such an approach would significantly reduce the possibility of further retrenchment in the size and diversity of client clearing availability.

Conclusion

CME Group strongly advocates for the adoption of a revision to the leverage ratio to recognize the market structure for centrally cleared derivatives by allowing segregated client initial margin to offset leverage exposure, ideally via Option 3. It is crucial that the leverage ratio framework recognize the market structure for centrally cleared derivatives and we appreciate the ongoing analysis that BCBS is performing as it considers adopting these changes.

We would be happy to further discuss and clarify any of the above remarks with the BCBS. If you have any comments or questions regarding this submission, please feel free to contact me at +1 312 634-

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[11] *See* Justin Baer & Juliet Chung, Goldman Sachs Cuts Roster of Hedge-Fund Clients, Wall Street Journal, Aug. 4, 2014, *available at* https://www.wsj.com/articles/goldman-rethinks-services-it-provides-hedge-funds-1407194493; Kelly Bit & Michael Moore, BofA Said to Oust 150 Hedge Fund Clients Under New Rules, Bloomberg, Jan. 13, 2015, *available at* https://www.bloomberg.com/news/articles/2015-01-13/bofa-said-to-oust-150-hedge-fund-clients-under-new-rules; Aaron Woolner, Credit Suisse Slashes Asia Commodity Futures Clearing Business, June 3, 2015, *available at* http://www.risk.net/asia-risk/news/2411383/credit-suisse-slashes-asia-commodity-futures-clearing-business; Luke Clancy, Are regulators listening at last on the leverage ratio?, Risk.net, Aug. 25, 2015, *available at* http://www.risk.net/risk-magazine/special/2423199/are-regulators-listening-at-last-on-the-leverage-ratio; Hayley McDowell, Self-clearing gains traction as banks continue to downsize clearing units, Trade News, Jan. 31, 2017, *available at* http://www.thetradenews.com/Post-trade/Self-clearing-gains-traction-as-banks-continue-to-downsize-clearing-units/; Laura Noonan & Joe Rennison, Deutsche Bank walks away from US swaps clearing, Financial Times, Feb. 9, 2017, *available at* https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655?ftcamp=engage%2Femail%2Fnewsletters%2Fsmart_brief%2Fsmartbriefnewsletterscontrafcf%2Faudev&segid=0800933; James Rundle, Clearing portability under threat as FCM pool shrinks, Risk.net, Feb. 23, 2017, *available at* http://www.risk.net/risk-management/3912341/clearing-portability-under-threat-as-fcm-pool-shrinks.

[12] *See* Stafford Philip, BoE backs derivatives leverage ratio rethink, Financial Times, July 5, 2016, *available at* https://www.ft.com/content/320829d8-42b7-11e6-b22f-79eb4891c97d; J. Christopher Giancarlo, Chairman Commodity Futures Trading Commission, Changing Swaps Trading Liquidity, Market Fragmentation and Regulatory Comity in Post-Reform Global Swaps Markets (May 10, 2017), *available* at https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22; Basel Committee on Banking Supervision, Committee on Payments and Market Infrastructures, Financial Stability Board, and International Organization of Securities Commission, final report, *Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms* (Nov. 2018); FIA SmartBrief, Quarles: Put derivatives-clearing offset in capital rules, MLex, Nov. 16, 2018, *available at* https://www2.smartbrief.com/servlet/encodeServlet?issueid=6E84EBB7-E36E-4ABE-8656-8FE70FB711ED&sid=af5dae03-0b0a-449d-a2fc-f7f0eaaff89a; Brian Quintenz, Commodity Futures Trading Commission Commissioner, Statement before Market Risk Advisory Committee (Dec. 4, 2018), *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement120418.

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