November 2, 2015

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: End-User Proposal to Mitigate the Detrimental Impact of the Leverage Ratio on Consumers and Investors

Dear Sirs and Madams:

The Commodity Markets Council ("**CMC**")[1] and Managed Funds Association[2] ("**MFA**", and together with CMC, "**we**") appreciate the opportunity to provide comments to the Basel Committee on Banking Supervision (the "**Basel Committee**") to express our concerns with the treatment of segregated initial margin for centrally cleared derivatives exposure under the Basel III leverage ratio (the "**Leverage Ratio**").[3] We support central clearing and our respective members are substantial users of central counterparty ("**CCP**" or "**Clearing House**") clearing services for both exchange-traded and cleared over-the-counter (OTC) derivative contracts, and their demand for clearing services will increase as different regulators fully implement their respective mandatory clearing initiatives. As buy-side

[1] The Commodity Markets Council is a trade association that brings together commercial end-users and the exchanges and the clearinghouses they access, to trade centrally cleared derivatives in order to manage risk. CMC members include commercial end-users, which utilize the futures and swaps markets for agriculture, energy, metal and soft commodities. Our industry member firms include regular users and members of such designated contract markets as the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Minneapolis Grain Exchange and the New York Mercantile Exchange. They also include users of registered swap execution facilities with the U.S. Commodity Futures Trading Commission.

[2] Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[3] *See* Basel Committee on Banking Supervision, Basel III Leverage Ratio Framework and Disclosure Requirements ("**BCBS 270**") (Jan. 12, 2014), available at http://www.bis.org/publ/bcbs270.htm.

market participants and end-users[4] of centrally cleared derivatives, our respective members access CCPs as clients of clearing members under contractual relationships with clearing members that enable them to clear derivative contracts indirectly with the relevant CCP.

The Leverage Ratio, as currently formulated, has begun to and will continue to threaten the ability of our respective members to use centrally cleared derivatives. If the Leverage Ratio is not modified, we believe that it will substantially reduce end-users' access to clearing and thereby limit hedging opportunities for commodity producers, investment managers and other customers to hedge their risks. As explained below, this outcome may result in market distortions in the real economy and increased systemic risk in the financial markets.

To avoid these detrimental results, we respectfully urge **the Basel Committee to modify the Leverage Ratio to recognize that segregated initial margin reduces the off-balance sheet exposures of a clearing member** ("**Clearing Member"**) and cannot be used by the Clearing Member to leverage itself. T**he Leverage Ratio should recognize the exposure-reducing effect of segregated initial margin posted to a central counterparty** ("**CCP Initial Margin"**) **consistent with other aspects of the Leverage Ratio.**[5] The Leverage Ratio should also provide an offset for client initial margin that is required to be segregated under an appropriate regulatory regime. Even with these modifications, the "simple, non-risk based 'backstop' measure" of the Leverage Ratio will not be disrupted.[6] A Clearing Member would still incur an off-balance sheet exposure for any difference between the value of segregated margin and the value of the Clearing Member's guarantee to the CCP. In requesting this modification, we echo the concerns recently expressed by Chairman Timothy Massad with the U.S. Commodity Futures Trading Commission ("**CFTC**") with respect to the current formulation of the Leverage Ratio: "I support having strong capital requirements on banks, including the [Leverage Ratio]. I am concerned, however, about how the [Leverage Ratio] may measure a clearing member's exposure arising from cleared derivatives. The measurement methodology uses a schedule based on the notional amount of the trade. It does not take into account the collateral collected from a customer that is posted to – and held by – the clearinghouse."[7]

---

[4] This letter uses the term "end-user" to refer broadly to entities that use derivatives as investment and risk management tools including, without limitation, asset managers, investment managers, manufacturers, and other commercial and industrial entities.

[5] As discussed in Section IV. below, the Leverage Ratio currently permits collateral offsets for securities financing transactions (**SFT**) in which a bank is acting as agent and providing an indemnity or guarantee to a customer or counterparty. As we explain in Section IV., the same principles for SFT offsets could be extended to cleared derivatives transactions, permitting an offset for the Clearing Member's off-balance sheet exposures where segregated initial margin is held by the CCP.

[6] BCBS 270 at p. 1.

[7] Keynote Remarks of Chairman Timothy Massad before the Risk USA Conference, as prepared for delivery on October 22, 2015.

In addition, we understand that the Basel Committee is considering modifying the Current Exposure Method ("**CEM**") to use the Standardized Approach for Measuring Counterparty Credit Risk Exposures ("**SA-CCR**"). We support this modification because the SA-CCR method, with offsets for segregated margin, would more accurately capture the actual economic exposures that Clearing Members incur when providing clearing services to clients.

I. Cleared Derivatives Allow End-Users to Manage Price Risk and Volatility for Consumers and Investors

For over a century both commercial and financial end-users have been able to use exchange traded, centrally cleared derivatives to manage risk. Risk is natural in the physical commodity business. Risk arises due to a lack of predictability regarding the supply and demand of a given commodity, as well as other factors such as the cost of production, availability of storage, the cost of transportation and the seasonality or economic cycle of a given commodity. The transparency of centrally cleared derivatives also leads to price discovery, which is relied upon far outside the derivatives markets and reduces prices for end-users and, ultimately, consumers.

Cleared derivatives markets allow commercial end-users to manage these and other risks in order to serve consumers of goods such as bread, grains, meat, gasoline, and diesel, with reliability, lower prices, and a measure of pricing stability. Similarly, the cleared derivatives markets allow hedge fund managers and other financial end-users to manage the financial risks to their investors of their investment strategies. The majority of global hedge fund investors are state and municipal pension plans, corporate pension plans, university endowments and foundations. Hedge funds and managed futures funds serve as tools that enable investors to diversify their portfolios as they seek consistent and risk adjusted returns with low levels of volatility.

II. The Leverage Ratio's Threat to the Use of Cleared Derivatives by End-Users

The stability of the cleared derivatives markets has been due, in a large part, to the risk management tools deployed in the market. These tools include a payment guarantee of the end-user's obligations to the CCP by the Clearing Member, which promotes access to the market by the end-user but creates an exposure for the Clearing Member, and the collection of initial margin from the end-user, which reduces the Clearing Member's exposure such that the Clearing Member is willing to provide the guarantee. The initial margin is the end-user's money;[8] therefore, it is segregated from the funds of the Clearing Member where the end-user holds its account.[9]

---

[8] 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 margin. *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).

[9] End-users are not typically Clearing Members, therefore in order to access centrally cleared derivatives, they must open and fund an account at the Clearing Member.

While the Leverage Ratio captures the Clearing Member's guarantee to the CCP as an off-balance sheet exposure, the Leverage Ratio fails to recognize the exposure-reducing effect of segregated initial margin by providing an offset to the Clearing Member's off-balance sheet exposure. According to the Basel Committee, the reason for the lack of an offset for client initial margin is that segregated client initial margin not only offsets exposures, but also can be used by the Clearing Member for further leverage. In the U.S., segregation rules severely restrict the ability of initial margin to be held in anything other than extremely low-risk and extremely liquid assets, assuring that it is always available to absorb losses ahead of the bank.[10] Segregated initial margin is legally the client's money, whether it is held at the Clearing Member or the CCP. And, the substantial majority of segregated initial margin is posted to the CCP and is therefore entirely outside the control of the Clearing Member.[11] We suggest that the Leverage Ratio should provide an offset for client initial margin that is either posted to the CCP or is required to be segregated under an appropriate regulatory regime.

The Leverage Ratio's failure to recognize the purpose of segregated initial margin results in a threat to the use of cleared derivatives by end-users. Clearing Members incurring large Leverage Ratio exposures for the low economic exposure activity of clearing will raise prices on end-users significantly. The Leverage Ratio, as currently structured, will increase the cost of using cleared derivatives by more than five times current levels.[12] The impact of this substantial cost increase will mean that end-users may reduce their hedging activities to inadequate levels, which will result in price volatility for consumers so that food, gasoline, and other consumer goods become unaffordable, among other adverse consequences for consumers and investors. Notably, our respective members are already being impacted by the Leverage Ratio in that their fees for clearing services have increased since 2014 and many have been told to find clearing services elsewhere.[13]

III. Increased Systemic Risk will Result as a Consequence of the Leverage Ratio's Threat to Portability During Periods of Financial Stress

---

[10] In the United States, segregated margin cannot be reinvested except for investments in low-risk and highly liquid assets, such as U.S. government securities, managed "with the objectives of preserving principal and maintaining liquidity." *See* 17 C.F.R. § 1.25(b).

[11] Applicable U.S. margin and Clearing House regulations result in a significant majority of margin being passed onto the Clearing House. Although margin rules vary across jurisdictions outside of the U.S., non-U.S. margin frameworks for centrally cleared derivatives generally result in a substantial portion of margin held at the CCP rather than the Clearing Member.

[12] This estimate is based on CMC members' conversations with Clearing Members. The increase in costs would be due to increased fees for cleared derivatives. Our respective members also anticipate incurring business costs due to their diminished ability to hedge commercial and financial risks. *See also*, Fiona Maxwell, *Non-bank FCMs unlikely to fill OTC gap*, Risk, Oct. 7, 2015, *available at* http://www.risk.net/risk-magazine/news/2429225/non-bank-fcms-unlikely-to-fill-otc-gap#.

[13] Bank-affiliated Clearing Members play a critical role in the centrally cleared derivatives market. Regulations that cause them to cease offering client clearing services are counter to the mandate of the G-20.
According to data released by the CFTC, there is concentration of Clearing Members: 72% of the customer funds in segregation for futures contracts is held by 10 out of 73 clearing firms and 74% of the customer funds in segregation for cleared swaps is held by 10 out of 73 clearing firms with 8 clearing firms out of 73 holding the majority of customer funds for both futures and swaps. *See* CFTC Financial Data for FCMs (July 31, 2015), available at: http://www.cftc.gov/MarketReports/FinancialDataforFCMs/index.htm.

Segregated initial margin is also important in times of financial stress. Historically, Clearing Houses have been able to successfully port customers of failing Clearing Members to new Clearing Members in order for these customers to maintain their open positions and avoid disruption from volatile market conditions. This is at least in part due to the exposure-reducing benefits provided by CCP Initial Margin which is ported along with customer positions during a default. If this porting leads to a significant increase in capital costs for non-defaulting Clearing Members (without a related offset), the ability of non-defaulting Clearing Members to take on new customer positions will be greatly constrained, particularly in times of stress. Clearing Members have historically been willing to take on customers from failing Clearing Members because segregated margin plainly reduced the actual economic exposures involved in doing so.

Clearing Members being unable to accept the porting of non-defaulting customers during a Clearing Member default will ultimately result in mass liquidations of customer positions. Not only would this negatively impact the customers being liquidated, but the liquidations are likely to exacerbate volatility at the worst possible moment. This increased volatility could lead to additional defaults perpetuating the cycle of stress and reducing market participants' ability to withstand such stressful events. The negative impact to systemic financial stability of such a situation would be significant.

IV. Clearing Members' Off-Balance Sheet Exposures can be Modified in a Manner Consistent with Other Aspects of the Leverage Ratio

It is crucial to distinguish between on-balance sheet exposures and off-balance sheet exposures in the Leverage Ratio. These exposures, and the concerns with the treatment of on-balance sheet and off-balance sheet client initial margin, have been conflated in past discussions of the issue. We are **only proposing a modification for off-balance sheet exposures.**[14]

The primary issue our respective members face with the Leverage Ratio is its failure to recognize the exposure-reducing effect of segregated initial margin on a Clearing Member's **off-balance sheet** exposures. In our view, the basis for this treatment is flawed.

Certainly, segregated initial margin held by the CCP should be subtracted from the Clearing Member's off-balance sheet exposures because such an offset is consistent with other aspects of the Leverage Ratio. Specifically, the Leverage Ratio separately allows collateral offsets when calculating a clearing bank's exposure for any agency securities financing transaction ("**SFT**") in which the bank provides an indemnity or a guarantee to a customer or

[14] The current treatment of cash initial margin posted by clients as an on-balance sheet exposure is the result of accounting rules. We understand that while a limited number of Clearing Members have been able to move cash initial margin off-balance sheet (making it no longer additive to the Leverage Ratio's on-balance sheet exposure measure), the majority of clearing banks have not been able to obtain this accounting treatment. Importantly, this on-balance sheet move does not help a Clearing Member reduce its off-balance sheet exposure, which is the far greater exposure in this context. In short, this accounting treatment for a few Clearing Members should not lead the Basel Committee or any local prudential regulator to conclude that the detrimental impact of the Leverage Ratio on clearing can be or has been solved.

counterparty, where the guarantee obligation of the clearing bank is the difference between the exposure and the collateral value and the collateral is outside of the ownership and control of the clearing bank. We believe that the Basel Committee should apply the treatment of SFT to clearing relationships by authorizing the offset of collateral against exposure. The SFT example demonstrates that in the off-balance sheet context, it is appropriate for the off-balance sheet component of the Leverage Ratio to capture a bank's actual economic exposures by expressly recognizing an offset for collateral. A similar offset should therefore extend to cleared derivative transactions where the segregated initial margin is held by the CCP outside the ownership and control of the Clearing Member. As with SFTs, the difference between the value of the segregated client margin held by the CCP and the Clearing Member's guarantee to the CCP would capture the Clearing Member's actual economic exposure.

V. The Adoption of a SA-CCR Exposure Method with Offsets for Segregated Margin Would More Accurately Measure Exposure

We understand that the Basel Committee is considering modifying the Current Exposure Method ("**CEM**") to use the Standardized Approach for Measuring Counterparty Credit Risk Exposures ("**SA-CCR**"). We support this change, as the CEM is particularly punitive to commodity end-users. For example, as to "combination trades," which are common trades used to mitigate the risk related to delivery time periods for physical commodities, the CEM limits netting to 60 percent.[15] The lack of netting availability for these sorts of trades further increases the cost to Clearing Members of providing clearing services to end-users such as farmers and commodity producers. Unlike the CEM, SA-CCR reflects the exposure of interest rate derivatives through duration adjustments, reflects netting of exchange-traded derivatives, and allows for delta adjustments for options contracts. The natural solution is for a transition from the CEM to the SA-CCR method in order to more accurately capture exposures that Clearing Members face when providing clearing services to clients.

Therefore, we strongly urge the Basel Committee to adopt the SA-CCR exposure method be adopted, with recognition of the exposure-reducing effect of segregated margin on a Clearing Member's off-balance sheet exposures.

VI. Conclusion

We support the G-20 mandate of promoting the use of cleared derivatives. Where a policy, such as the Leverage Ratio, unnecessarily threatens end-users' use of cleared derivatives by increasing their costs and availability, our respective members will not be able to use cleared derivatives to manage their risks. The detrimental effects could have serious consequences to the real economy, including by increasing prices of consumer goods, and could lead to increased systemic risk.

---

[15] This limitation applies to calendar spreads—trades popular with agricultural participants where they enter into a long futures contract for a specific month and a short futures contract for a subsequent month in order to hedge their price risk.

We encourage the Basel Committee to introduce the SA-CCR method as soon as possible and to allow segregated margin to be subtracted from Clearing Members' off-balance sheet exposures in the application of the SA-CCR to the Leverage Ratio. Certainly, CCP Initial Margin, which is outside the control of the Clearing Member, should be subtracted from Clearing Members' off-balance sheet exposures because such an offset would be consistent with the treatment of agency SFTs under the Leverage Ratio. The Leverage Ratio should also provide an offset for client initial margin that is required to be segregated under an appropriate regulatory regime.

We appreciate your consideration of this letter. Should you have any questions regarding this letter, please contact Gregg Doud or Kevin Batteh at CMC at (202) 842-0400 and Stuart J. Kaswell or Laura Harper Powell at MFA at (202) 730-2600.

Respectfully submitted,

/s/ Gregg Doud

Gregg Doud
President
Commodity Markets Council

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director, General Counsel
Managed Funds Association

cc: U.S. Commodity Futures Trading Commission
The Hon. Timothy G. Massad, Chairman
The Hon. Sharon Y. Bowen, Commissioner
The Hon. J. Christopher Giancarlo, Commissioner

Board of Governors of the Federal Reserve System
The Hon. Janet L. Yellen, Chair
The Hon. Stanley Fischer, Vice Chairman
The Hon. Daniel K. Tarullo, Member
The Hon. Jerome H. Powell, Member
The Hon. Lael Brainard, Member

Board of Directors of the Federal Deposit Insurance Corporation
The Hon. Martin J. Gruenberg, Chairman
The Hon. Thomas M. Hoenig, Vice Chairman
The Hon. Thomas J. Curry, Comptroller of the Currency