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November 24, 2014

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

Re: **Increased Costs and Risks to Global Commodity Markets under the Basel III  
Supplementary Leverage Ratio**

Dear Sirs and Madams:

As commercial end-users that rely on the price discovery and risk management functions of exchange-traded derivatives that are centrally cleared (**ETDs**), we are gravely concerned about the potential effects of the Basel III supplementary leverage ratio (the **Leverage Ratio**)<sup>1</sup> on the costs and liquidity of ETDs and other centrally cleared derivatives.<sup>2</sup> We are concerned that the Leverage Ratio, as currently structured, will increase the cost of using ETDs by more than five times current levels.<sup>3</sup> Such a dramatic increase in costs will greatly discourage the use of ETDs and the exchanges and central counterparties (**CCPs**) that offer ETDs — undermining a key G-20 objective for reform of the derivatives markets<sup>4</sup> and diminishing the ability of end-users to effectively hedge risks and manage volatility. The likely result will be greater volatility in food, energy and other commodity-driven markets, which will ultimately impact consumers through increased prices for basic consumer products. It bears emphasis that every dollar a commodity end-user spends on increased clearing fees, and every dollar a commodity end-user loses as a

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<sup>1</sup> 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>.

<sup>2</sup> ETDs refers to both futures and swaps that are traded on regulated exchanges or trading platforms. Certain other derivatives, namely swaps, are centrally cleared and not traded on an exchange or trading platform.

<sup>3</sup> This estimate is based on our members' conversations with Clearing Members. We encourage BCBS to seek further data on likely cost increases under the Leverage Ratio as implemented by national authorities, including in the United States, or to undertake a broader Quantitative Impact Study on the treatment of cleared derivatives transactions under the Leverage Ratio. As discussed more fully below, the increase in costs would relate to both the fees for clearing ETDs as a result of increased margin requirements, as well as increased business costs resulting from the diminished ability of end users to hedge commercial risks.

<sup>4</sup> G-20 Leaders' Statement, The Pittsburgh Summit (September 25, 2009) ("All Standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties . . .").

result of un-hedged risk, is a dollar less spent on the production and distribution of industrial and agricultural goods.

The Commodity Markets Council (**CMC**) is a trade association that brings together commodities exchanges, intermediaries and their industry counterparts. Our members include commercial end-users, which utilize the futures and swaps markets for agriculture, energy, metal and soft commodities, as well as intermediaries and exchanges.<sup>5</sup> The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on designated contract markets, swap execution facilities or over-the-counter markets.

CMC has two principal concerns with the Leverage Ratio as currently applied to bank-affiliated clearing members (**Clearing Members**). First, the Leverage Ratio overstates Clearing Member leverage exposures because it does not account for the exposure-reducing effect of appropriately segregated margin held by a Clearing Member. Second, the Leverage Ratio overstates exposures associated with cleared derivatives generally because it applies a calculation method that does not appropriately differentiate between cleared and uncleared derivatives. If the Leverage Ratio is imposed on Clearing Members in its current form, it will impose on them capital requirements that are entirely out of proportion with the systemic risks posed by their business and will thus require them to dramatically increase the fees they charge commercial end-users, such as members of CMC, for clearing services.

CMC encourages the Basel Committee on Banking Supervision (**BCBS**) and national implementing authorities to carefully reevaluate the impact of the Leverage Ratio on central clearing costs and access. More specifically, we encourage the BCBS to work closely with end-users, clearing members, and central counterparties (**CCPs**) to alter the calculation of Clearing Member exposures on cleared derivative transactions so that the Leverage Ratio calculation accurately reflects the exposure-reducing effect of appropriately segregated initial margin and the limited exposure of Clearing Members on cleared derivatives.

***The Leverage Ratio overstates a Clearing Member's leverage exposures because it does not account for the exposure-reducing effect of margin held by a Clearing Member.***

Clearing Members act as brokers or agents of end-users in executing cleared derivatives transactions. In this capacity, they guarantee the end-user's performance on the transaction to the CCP. As the BCBS has recognized,<sup>6</sup> this guarantee is the sole exposure of a Clearing Member in a cleared derivative transaction.

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<sup>5</sup> Our industry member firms, listed on our website at [www.commoditymkts.com](http://www.commoditymkts.com), include regular users and members of such designated contract markets as the Chicago Board of Trade, the Chicago Mercantile Exchange, ICE Futures US, the Minneapolis Grain Exchange and the New York Mercantile Exchange. They also include users of swap execution facilities.

<sup>6</sup> BCBS 270 at ¶ 28 ("Where a client enters directly into a derivatives transaction with the CCP *and the CM guarantees* the performance of its clients' derivative trade exposures to the CCP, the bank acting as the clearing member for the client to the CCP must calculate its related leverage ratio exposure *resulting from the guarantee* . . .") (emphasis added).

The Clearing Member's guarantee, however, is not the only form of security obtained by the CCP. Rather, the CCP requires that Clearing Members collect a minimum level of collateral, referred to in this letter as "**segregated margin**,"<sup>7</sup> from end-users both at the time they enter into derivative transactions and on an ongoing basis thereafter. Clearing Members may also impose additional segregated margin requirements on end-users. Segregated margin offsets the exposure of the Clearing Member on its guarantee as, in effect, the Clearing Member only guarantees the end-user's performance to the extent that performance has not already been secured by segregated margin.

The Leverage Ratio generally prohibits banks from netting collateral against exposures on the basis that collateral can "increase the economic resources at the disposal of the bank, *as the bank can use the collateral to leverage itself*."<sup>8</sup> Yet, unlike other forms of collateral, where segregated margin is held by a Clearing Member it is held subject to robust regulatory or contractual segregation requirements. In the U.S., for example, segregated margin is held at CCPs or in segregated, bankruptcy-remote accounts.<sup>9</sup> It can only be used to meet the obligations of the relevant end-user to the relevant CCP, and it can only be invested in specified, ultra-safe and highly liquid investments. Both in the U.S. and in other jurisdictions, segregated margin simply cannot be used by a Clearing Member to leverage itself. There is therefore no basis for preventing a Clearing Member from netting segregated margin received in relation to a derivatives transaction against the Clearing Member's exposures on that transaction.

***The Leverage Ratio uses an imprecise calculation method and does not appropriately differentiate between cleared and uncleared derivatives.***

Derivatives exposures under the Leverage Ratio are calculated using an imprecise approach known as the Current Exposure Measure (**CEM**).

Under the CEM, derivatives exposures are principally quantified through a calculation that adds the fair value of a derivative to potential future exposures on that derivative. Potential future exposures are calculated by multiplying the notional principal amount of the derivative by an

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<sup>7</sup> As used in this letter, the term "segregated margin" refers to margin that is segregated in a manner consistent with the segregation requirements imposed by the U.S. Commodity Futures Exchange Commission through 17 C.F.R. §§ 1.20-1.30 and 22.2-22.7, the U.K. Financial Conduct Authority through the Client Assets Sourcebook, §§ 7.3.1–7.3.2, and similar regulatory and contractual requirements imposed in other jurisdictions. Further, because the Leverage Ratio appropriately recognizes the exposure-reducing effect of cash received as a result of the end-user's ongoing obligation to post variation margin, see BCBS 270 at ¶ 25, the term "segregated margin" as used in this letter excludes variation margin and principally refers to initial margin posted at the time of entry into a derivatives transaction.

<sup>8</sup> BCBS 270 at ¶ 22 (emphasis added).

<sup>9</sup> See 17 C.F.R. §§ 1.20-1.30 (futures) and 17 C.F.R. §§ 22.2- 22.7 (cleared swaps). In jurisdictions outside the United States, similar restrictions may be imposed either by rule or by contract. See, e.g., U.K. Financial Conduct Authority, Client Assets Sourcebook, §§ 7.3.1–7.3.2.

“add-on factor.” The size of the add-on factor varies based on the type of derivative and its residual maturity. The longer the maturity, the higher the add-on factor. As a result, end-users taking long-term, directional positions to hedge risk are impacted to a greater extent than short-term and algorithmic traders. Moreover, the add-on factors for the commodity derivatives typically used by CMC members are higher than the add-on factors for all other derivatives, which leaves CMC members uniquely exposed to likely increases in clearing costs and to diminished access to hedging markets.

The BCBS itself has recognized the limitations of the CEM, including that the CEM fails to adequately capture the netting benefits associated with cleared derivatives transactions.<sup>10</sup>

***Failure to address these issues will dramatically increase clearing fees, diminish the ability of end-users to effectively hedge risks, and ultimately impact end consumers.***

In failing to account for the exposure-reducing effects of margin and netting, the Leverage Ratio inappropriately inflates the amount of capital that Clearing Members must hold, driving up their costs. It follows that, to maintain reasonable returns on capital, Clearing Members will significantly increase fees charged to CMC’s members. Alternately, Clearing Members may simply exit the clearing business, reducing access for end-users and increasing concentration in derivatives clearing. As noted, increased costs and reduced access are particularly likely for the directional commodity derivatives that CMC’s members use — and have used for over 150 years — to hedge their fundamental business risks.

If the cost of use of cleared derivatives increases, CMC’s members may be forced to leave their portfolios fully or partially unhedged, increasing their downside risk. Some CMC members may also withdraw from the cleared derivatives markets entirely, which could significantly impact the liquidity of commodity derivatives products and increase basis risk for commercial hedgers. As a result, end-users will be less able to effectively hedge risk and volatility in commodity prices. Ultimately, this will result in higher prices for commodity-based consumer products at the grocery store and at the gasoline station.

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To avoid these negative impacts to the global commodity markets, CMC recommends that BCBS consider (1) clarifying that Clearing Members can net segregated margin against their exposures on cleared derivatives and (2) adopting an exposure calculation methodology that accounts for the benefits of netting. In this connection, we note that BCBS recently adopted the standardized approach for measuring counterparty credit risk exposures (the **SA-CCR**) as a replacement for the CEM in the risk-based capital context. Replacing the CEM with an SA-CCR

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<sup>10</sup> See Basel Committee on Banking Supervision, Consultative Document: The non-internal model method for capitalising counterparty credit risk exposures (**BCBS 254**) (as amended, Jul. 25, 2013), at ¶ 6, available at <http://www.bis.org/publ/bcbs254.htm> (recognizing the criticism that “[t]he recognition of hedging and netting benefits through [the CEM net-to-gross ratio] is too simplistic and does not reflect economically meaningful relationships between the derivative positions.”)

approach that duly recognizes the exposure-reducing effects of segregated margin would address our concerns.<sup>11</sup>

Absent action by BCBS, we remain concerned that the Leverage Ratio may act as an effective tax on commodity production. Indeed, the Leverage Ratio appears likely to drive Clearing Members away from central clearing; increase clearing costs and the concentration of clearing services; reduce access to the market for end-users; and ultimately increase systemic risk by making global commodity markets less liquid and more volatile.

We note that other market participants, including Clearing Firms and CCPs, have made similar submissions either individually or through trade associations;<sup>12</sup> we fully endorse their positions.

CMC appreciates your consideration of this letter. Should you have questions regarding this topic, please contact me at [Gregg.Doud@commoditymks.org](mailto:Gregg.Doud@commoditymks.org) or by phone at 202-842-0400 (x101).

Sincerely,



Gregg Doud  
President  
Commodity Markets Council

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<sup>11</sup> BCBS 270 expressly contemplates that the CEM may be replaced by any improved methodology adopted in the risk-based capital context. See BCBS 270 at ¶ 19 n. 5.

<sup>12</sup> See Letter from Walter Lukken (Futures Industry Association) to BCBS, November 18, 2014, and Letter from Timothy W. Cameron Esq. and Matthew J. Nevins Esq. (Asset Management Group Securities Industry and Financial Markets Association) to BCBS, November 18, 2014.