



Subject: Consultation on Revisions to the Basel III leverage ratio framework

Amsterdam, 6 July 2016

Dear Sir/Madam,

We, ABN AMRO Clearing Bank (AACB)¹, Akuna Capital, Atlantic Trading London, Barak Capital, BATS Global Markets, BOX Options Exchange, Chicago Board Options Exchange (CBOE), CSS, DRW, Eurex, Eurex Clearing, Financial Market Engineering (FME), Flow Traders, Geneva Ireland Financial Trading, IMC Trading, Intercontinental Exchange (ICE), Jane Street Financial, Liquid Capital Markets, Mako Global Derivatives Partnership, Maven Derivatives, NASDAQ, The Options Clearing Corporation (OCC), Optiver, Osaka Exchange, OSTC, Quantlab Financial, Ronin, RSJ, Spire Europe, Sun Trading, TOM MTF, Tyler Capital Partners, Virtu Financial and Volant Trading have taken note of the Consultative Document on Revisions to the Basel III Leverage Ratio (LR) Framework. We strongly welcome the proposed revisions in the document and are writing to you in order to re-emphasise the position we communicated in our letter dated 27 October 2015. This consultation response aims to provide additional background and data to reiterate our concerns.

We continue to believe that unless the Standardised Approach for Counterparty Credit Risk (SA-CCR) method is allowed as a replacement for the Current Exposure Method (CEM) in the leverage calculation for exchange-traded derivative (ETD) exposures, the application of the LR will result in vastly increased

¹ ABN AMRO Clearing Bank N.V. is a wholly owned subsidiary and stand-alone entity within ABN AMRO Bank N.V. (AAB) that hold its own banking license. AACB is a leading global General Clearing Member and market access provider on all major exchanges, liquidity pools and Central Counterparties (CCPs) across Europe, the Americas and Asia Pacific. AACB is not engaged in proprietary trading and solely executes and clears for the risk and account of clients.

capital requirements for general clearing members (GCM)² offering clearing services to market makers and liquidity providers. This will fundamentally threaten their business models and impact the liquidity and stability of global financial markets. We believe this would be contrary to the G20 commitments on central clearing.

We thank the Basel Committee on Banking Supervision (BCBS) for their efforts in reconsidering the application of the CEM methodology. This will allow us to work towards an appropriately calibrated and sustainable leverage ratio framework without creating serious economic disincentives for participants in the ETD market. The proposed revisions and the introduction of a modified version of SA-CCR would dramatically reduce the unintended consequences we currently face based on CEM.

Furthermore, we strongly support broader industry concerns related to the limitations of segregated client-related margin offset and the recognition of their exposure reducing effects, as expressed for by – amongst others – the Futures Industry Association (FIA) and CCP12.

1. The problem GCMs face with CEM in the ETD markets:

Based on BCBS Paper 270³ related to the calculation and reporting of the Leverage Ratio (LR), the BCBS issued the LR framework and disclosure requirements as a backstop to the risk-based capital standards to provide a simple, transparent, non-risk based, credible supplementary measure to the risk-based capital requirements.

At the same time, regulators across the globe have endeavoured to shape the OTC derivatives market to resemble that of the exchange-traded derivatives (ETD) market – favouring central clearing and on-venue trading of contracts to ensure that these markets become more standardised, more transparent, and above all, to mitigate systemic risk. This resulted in the implementation of the global central clearing obligations agreed by the G20 that aim to address systemic and counterparty risk in derivatives transactions.

However, the material impact of the LR for GCMs and their clients under CEM is strongly at odds with the G20 commitments. Our concerns focus around four key areas: i.) Limitations of the applicable netting rules, ii.) Implications for market makers and liquidity providers, iii.) Implications for general clearing members under the client clearing model, and iv.) The lack of a level playing field between the European Economic Area (EEA) and United States of America (US).

1.1. Limitations of the applicable netting rules

Under the Current Exposure Method (CEM) the leverage ratio breaks derivatives exposure for GCMs into two components:

- The replacement cost, which is a measure of its current (Mark-to-Market) value;
- The potential future exposure (PFE), based on a simple grid, with product type on one axis and maturity on the other, generating 15 different multipliers that are applied to the notional value of a trade to calculate the PFE add-on.

The LR does not take the different characteristics and risks of ETD and OTC instruments into account. For ETD, we believe that a different treatment compared to OTC derivatives would be warranted recognising the applicable netting rules and CCP clearing processes.

² The reference to General Clearing Member refers to all applicable clearing models in multiple jurisdictions and includes the bank-owned Futures Commission Merchant (FCM) and Broker/Dealer model in the United States.

³ Implemented in the EEA as Commission Delegated Regulation (EU) 2015/62 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to leverage ratio.

We believe that under CEM potential future exposures (PFE) of ETDs are at odds with the risk limiting nature of certain transactions and the concept of CCP-clearing in general (if no proper netting would be allowed). CEM also fails to recognise the difference in exposure for directional trades and those mitigating risk. The (simplified) example below explains this further pursuant to applicable rules in the EEA.

Figure 1: Impact of CEM

The adverse impact of the CEM on GCMs, market makers and liquidity providers can be illustrated by the following example.

- GCM Client A and B have positions in Company X options (shares trading at 24EUR) and a contract size equal to 1.
- GCM Client A's position consists of 100 short call Company X options with strike price 24 and expiration in December.
- Client B's position is part of a hedging strategy and consists of 100 short call Company X options with strike price 24 and expiration in December and 100 long call Company X s options with strike price 26 and expiration in December.

The table below shows the exposure where the CEM to be applied (no netting allowed).

Client	Position(s)	Option	Strike	Expiration	Exposure
A	100 short Call	Company X	24	December	2.400
B	100 short Call	Company X	24	December	2.400
	100 long Call	Company X	26	December	2.600

- Based on the CEM method Client A receives a total exposure of 2.400 and client B a total exposure of 5.000.
- However, the total exposure of client B should actually be equal to $\text{abs}(24-26)*100 = 200$, due to offsetting positions.

In the (simplified) example described above, Client A represents a trader with an unhedged outright (directional) position, whereas Client B represents a market maker that has a largely hedged position as part of a liquidity providing strategy.

1.2. Implications of CEM for market makers and liquidity providers

Market makers and liquidity providers perform essential services to facilitate efficient price discovery in the global markets using their own proprietary capital; they represent up to 40% of turnover on global markets. Market makers in general ensure there is a buyer for every sell order and a seller for every buy order at any time, including in times of market stress. Their crucial role was previously underlined in a BIS Working Paper from May 2016⁴.

Designated market makers at trading venues are subject to binding presence requirements to provide two-way quotes for up to 90% of the trading day. In return for providing this liquidity, market makers seek economic returns based on option trade spreads while maintaining risk-neutral portfolios. Furthermore, pursuant to MiFID-II, undertaking market making strategies in the EEA will formally introduce a clear set

⁴ See the recent BIS Working Paper, No. 563: Who supplies liquidity, how and when? (May 2016), available at: <https://www.bis.org/publ/work563.pdf>

of obligations to provide quotes and have a presence in the market on a continuous basis, including on the electronic ETD markets favoured by the G20 commitments⁵.

Paradoxically, as a result of not recognising the netting effects shown in figure 1 above, the LR exposure for a GCM based on the position of a hedged market maker (GCM Client B) is 100% larger than for a trader with an outright (unhedged) position (GCM Client A). This is despite the fact that the actual (credit) risk associated with the (risk-constrained) position of the market maker (Client B) is limited to only 200, while the (credit) risk associated with the position of the trader with an outright position (Client A) is theoretically unlimited.

We therefore believe that the CEM is potentially only appropriate for a directional long or short position. Given the example above, CEM is inappropriate for risk-constraining positions of market makers that typically carry large inventories of derivatives, but overall have a very low risk profile.

1.3. General Clearing Member Implications under the client clearing model

The inherent feature of the client clearing model of a GCM is the application of effective methodologies for mitigating counterparty and market risks for their clients, while guaranteeing the client's performance to the infrastructure. The majority of GCMs offering client clearing operate in multiple jurisdictions under different legal setups with different CCPs (governed by CCP rule books and applicable local legislation). Depending on the operational and legal setup, GCMs can be seen as acting as principal or agent vis-à-vis the client and/or the CCP in a derivative transaction under the client clearing model.

In the US, a GCM is an agent by law, whereas in the EEA it is mostly based on a principal relationship between the GCM and CCP, but always for the risk and account of its clients. Economically, this model is similar to the agency model applicable in the United States with the main difference that under the US model the GCM is not a contract party with respect to the derivative with the CCP. Regardless of the legal setup, GCMs always **guarantee** the client's position to the infrastructure.

As a result of this guarantee, CEM particularly fails to recognise the business models for both market makers and their GCMs if exposures of trading firms with matched (hedged) positions and large inventories can no longer be netted.

Since the reporting of the LR commenced in the EEA in January 2015, the implication of CEM has translated into extremely high additional exposures for GCMs.⁶ Consequently, these additional exposures result in a vast increase in capital requirements that comes in addition to the already increased Own Fund requirements for bank exposures to CCPs under the Basel III framework.

Figure 2 below demonstrates that the additional LR exposure under CEM will have an adverse effect on the ability of an EEA-based GCM to facilitate market makers and liquidity providers. We believe this is to the detriment of overall market quality and will result in serious economic constraints for firms to i.) undertake market making activities on trading venues; ii.) provide the necessary liquidity in the global ETD markets; and iii.) for GCMs to service and guarantee such positions. Figure 2 below shows the implications for ABN AMRO Clearing Bank N.V. specifically.

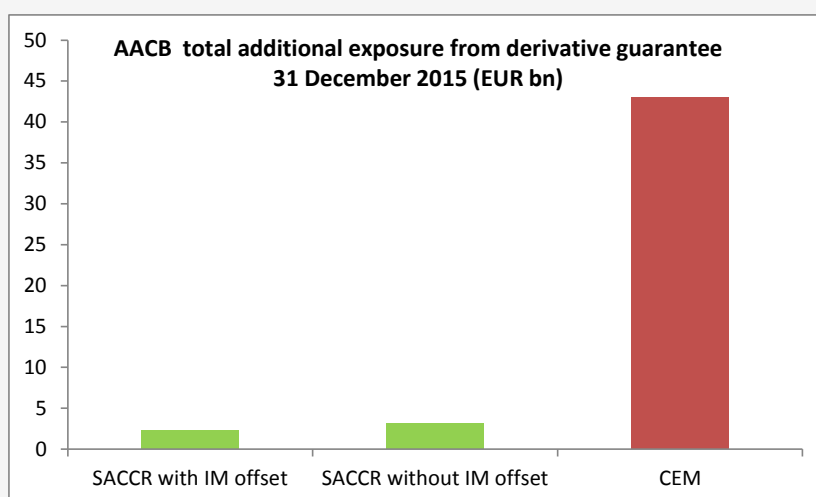
⁵ Cf. Art. 17(3) and (4) of Directive 2014/65/EU (MiFID-II) and the associated Commission Delegated Regulation C(2016) 3523 final, with regard to regulatory technical standards specifying the requirements on market making agreements and schemes (published on June 13, 2016).

⁶ For example, during Q2 of 2015, ABN AMRO Group's fully-loaded leverage ratio decreased to 3.1% at 30 June 2015 compared with 3.5% at 31 March 2015.

https://www.abnamro.com/en/images/Documents/050_Investor_Relations/2015/ABN_AMRO_Quarterly_Report_second_quarter_2015.pdf

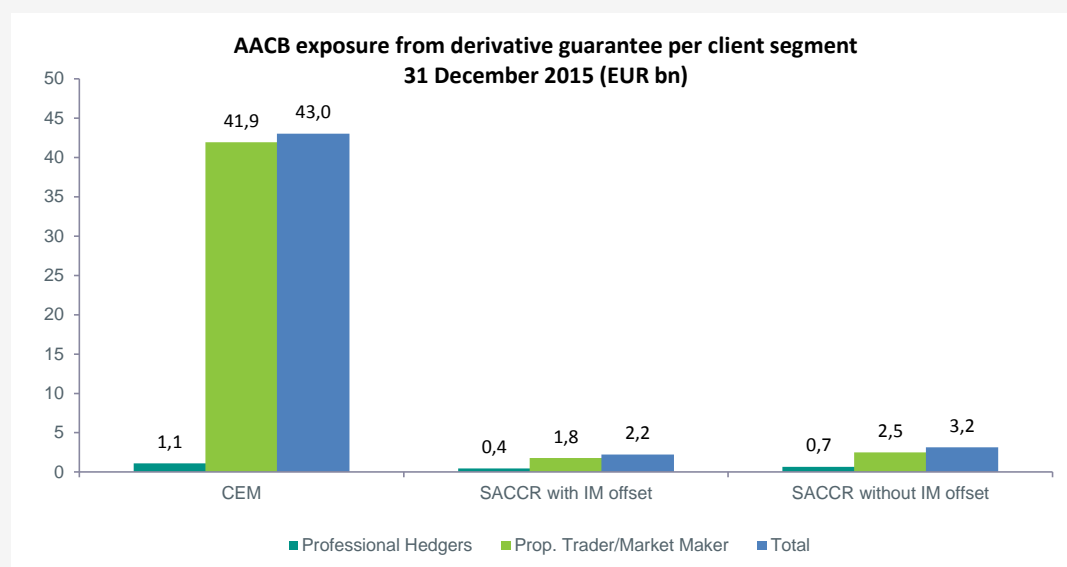
Figure 2: ABN AMRO Clearing Bank N.V.

The main client base of AACB consists of principal traders and commodity hedgers with matched (two-way) positions and large inventories. If no netting is allowed, guaranteeing these as aggregate gross positions presently result in an additional unrealistic exposure of more than € 50 billion for ABN AMRO at group level under CEM. The diagram below shows the differences in exposure between CEM, SA-CCR with initial margin (IM) offset and SA-CCR without IM offset. (Note that AACB has no proprietary/house positions).



Source: ABN AMRO Clearing Bank N.V.

If these figures are further broken down by client segment (see below), the impact of netting not being allowed becomes abundantly clear for market makers and liquidity providers; it increases the exposure under CEM for this segment by 2000%. The substantial increase in additional capital requirements challenges the sustainability of the business model and will lead to soaring clearing costs. Unfortunately, the Quantitative Impact Study (QIS) did not include a specific metric for market makers and liquidity providers.



Source: ABN AMRO Clearing Bank N.V.

1.4. Lack of a level playing field

Lastly, under the current interpretations in the European Economic Area (EEA) pursuant to the Capital Requirements Regulation (CRR), CEM does not recognise netting benefits for ETD, but only for "perfectly matching OTC derivative contracts". This is also stated in the European Banking Authority (EBA) Single Rulebook Question 2014-798 where EBA explains that only 'perfectly matching OTC contracts' can be netted when risk positions are opposite and all their other features are identical.

In addition, the implementation with regard to LR calculations in the EEA is different compared to the United States of America (US). Following BCBS Paper 227 on capital requirements for bank exposures to central counterparties (article 113), the Exposure at Default (EAD) for trade exposures towards qualifying CCPs (QCCP) based on clearing member exposures to clients under CEM is multiplied by an adjustment factor between 0.71 and 1.00 depending on the margin period of risk. In the EEA, this is implemented in the CRR⁷ for both qualified CCPs (QCCP) and non-qualified CCPs. For QCCP, and in conformity with BCBS Paper 227, this is also the case in the US.⁸

The adjustment factor is not part of BCBS Paper 270 on the Leverage Ratio, nor is it part of Regulation (EU) 2015/62 implementing the LR in the EEA. However, it seems to be part of the LR calculations in the US⁹. This results in EEA-based GCMs having a capital requirement based on the LR that is 41% higher than in the US if the adjustment factor 0.71 can be applied.

We believe that different interpretations across jurisdictions and regulators jeopardise a level playing field across the globe.

2. Unintended consequences

Given the discrepancies between the G20 commitments on central clearing and punitive capital requirements for GCMs as a result of the CEM, we note that a number of GCMs have already ceased their operations while others are re-assessing their business models. Data from the Commodity Futures Trading Commission (CFTC)¹⁰ shows a steady decrease in the number of FCMs, while at the same time the number of total cleared client assets has increased significantly driven by new clearing mandates since 2009.

We fear that a further reduction of GCMs will result in an undesirable lack of choice for end-users and decrease available (global) balance sheet capacity for clearing of derivatives transactions, including those that are anticipated to become subject to mandatory clearing.

More worryingly, a further reduction in the number of available GCMs heightens the risk that clients of a clearing member that has defaulted will be unsuccessful in porting their positions to a "back-up" GCM. Based on the current LR and RWA interpretations, no other GCMs may be able or willing to take up such positions given the impact it will have on its overall exposures. If the mandatory application of CEM were to continue, it would likely prompt further GCMs to reduce their activities given the heavy restrictions on netting that will impose overly burdensome capital requirements.

⁷ Capital Requirements Regulation (CRR), see Article 304(4)), there for all CCP, not only for QCCP)

⁸ See §34(e) on p. 62183 and 62184 and §132(c)(8), p. 62219 in Federal Register Vol. 78, No. 198. Friday October 11, 2013, Federal Reserve System 12 CFR Parts 208, 217, and 225 Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transitional Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Final Rule).

⁹ See p. 62033, §34(e) on p. 62183 and 62184, in conjunction with paragraphs §10(a)(5) on p. 62170, §10(c)(4) on p. 67121 and the definition of 'total leverage exposure' in §2 on p. 62169, all in the above-mentioned Final Rule).

¹⁰ http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/aac092215presentations_dsio.pdf

Likewise, the CEM methodology will impact ETD market makers and liquidity providers. Since banks had to cease or strongly reduce their traditional market making activities as a side-effect of needing to strengthen their regulatory capital position and reducing excessive leverage in the banking system, non-bank market makers and liquidity providers that trade with proprietary capital for their own risk have become a critical source of liquidity in the global financial infrastructure; they play a key role in contributing to stable, reliable, efficient and well-functioning markets.

Furthermore, if under CEM no netting would be allowed for such (risk-limiting) strategies, firms would not be able to continue to make markets, and market liquidity will be seriously affected leading to higher spreads, lower volumes, more volatility and greater systemic risk. The end result of this will be higher prices for consumers of food and energy, as well as for employees relying on professionals to manage their retirement portfolio.

The clients of GCMs will also be hit by the impact of the LR as they will face higher clearing costs, a reduction in choice of providers and constraints on risk diversification. Moreover, the netting limitation in the ETD market will lead to market participants becoming incentivised towards placing tailored bilateral or cleared OTC trades rather than trading in more liquid and transparent ETD markets.

In conclusion, we strongly believe there will be potential systemic complications by retaining the CEM prior to the adoption of a binding LR in 2018.

The solution:

We encourage the efforts by the BCBS to address the unintended consequences and shortcomings of the CEM methodology for CCP exposures and request the BCBS to replace it with a modified version of the SA-CCR method. We continue to believe that SA-CCR provides better differentiation between margined and unmargined trades and provides more meaningful recognition of netting benefits.

We are more than willing to clarify our position verbally, e.g. in a conference call or in person if needed. For further questions, please contact Matthijs Geneste at ABN AMRO Clearing Bank via matthijs.geneste@nl.abnamro.com.

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