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Options Clearing Corp.

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Options Clearing Corp.

Rationale

Counterparty Credit Rating
AA+/Stable/--

Business risk

- Effective monopoly on clearing equity options and futures
- Critical function in the U.S. capital markets
- Significant economies of scale
- Only moderate concentration in underlying instruments
- High degree of operational risk

Financial risk

- Great flexibility to reduce refunds or raise clearing fees if needed
- Minimal debt

Clearing and settlement risk

- Large, diversified member base with average credit quality
- Risk concentration to largest five clearing members
- Sound margining system, but relatively weaker pool of liquidity resources than European peers in a clearing member default scenario

Outlook

The stable rating outlook incorporates our expectation that Options Clearing Corp. (OCC) will maintain its cautious risk appetite and preserve the sound quality of its financial safeguards.

Downside scenario

We would most likely lower the ratings if the company materially weakened its financial safeguards.

Upside scenario

We consider an upgrade unlikely over the rating horizon.

Standard & Poor's Base-Case Scenario

Assumptions

Profitability is not a major ratings factor, as OCC operates as a utility for its members, focusing on cost recovery rather than on maximizing profit. Bottom-line profitability after refunding clearing members historically has been, and is likely to remain, below peers.

Key metrics

	2014A	2015E	2016E
Debt/EBITDA	0.4x	[0.3x-0.5x]	[0.3x-0.5x]
FFO/debt	111%	[100%-115%]	[100%-115%]
EBITDA interest coverage	18.9x	[17x-20x]	[17x-20x]

A-Actual. E—Expected.

Company Description

Founded in 1973, OCC is a stand-alone clearinghouse that issues and clears options and futures on common stocks, indices, currencies, and interest rate composites listed on 12 participating exchanges, of which five are shareholders. OCC enjoys an effective monopoly for clearing these options products in the U.S., although it is not granted monopoly rights by law. In addition, OCC provides central counterparty services for two securities lending market structures, OCC's OTC Stock Loan Program and Automated Equity Finance Markets Inc., an automated marketplace for securities lending and borrowing.

Since July 18, 2012, and as part of the Dodd-Frank financial overhaul, OCC was designated a systemically important financial market utility. As such, the Federal Reserve has become a third regulator, along with the Commodity Futures Trading Commission and the Securities and Exchange Commission, with some form of supervisory role.

Business Risk

Our assessment of OCC's business position as "excellent" reflects its status as a quasi-monopoly in the U.S. options market and the critical function it performs for U.S. capital markets. The significant economies of scale and only moderate concentration in underlying instruments that the U.S. options market affords further supports our view of the company's business risk profile. The 12 participating exchanges list derivative instruments on more than 4,000 underlying instruments. Options clearing (on single-stocks or indices) represent the overwhelming majority of total volumes that OCC clears. Futures on the VIX volatility index (CFE) represented 75% of all futures cleared at OCC in 2014. Total notional on stock lending transactions cleared at OCC surged to about $85 billion in 2014 from a little under $40 billion in 2013. We expect stock lending clearing volumes to rise again this year as Basel III regulation provides regulatory capital incentives for banks to have such transactions cleared.

The company enjoys large economies of scale and has ample capacity to absorb up to 2.5 times the largest historical trading volumes per day with the current OCC systems. As a processor of thousands of transactions daily, we consider OCC's operational risk to be high. The company must meet the demands of its members and the trading community at large, which requires exceptional technology and back-office operations. Reliability, availability, scalability, security, and constant innovation are only a few of the challenges. In line with the nature of OCC's business, operational risk is high but receives appropriate attention and resources and is well managed (including technology and recovery centers), in our opinion.

There is a high degree of operating leverage because revenues are variable, highly unpredictable, and dependent on the volume of options activity, and expenses are generally fixed. OCC also faces the cost of technology improvements, introducing new products, and expanding services to its members. According to a new capital policy OCC will implement in 2015, the clearinghouse now targets a profit margin of 25% (lower than the 31% that the company has achieved on average over the past five years). OCC will use these earnings to fund any required regulatory capital increase. The remaining income will be split 50/50 between dividends to the shareholder exchanges and member refunds. OCC can reset fees if necessary. Overall, bottom-line profitability after refunding clearing members historically has been, and is likely to remain, below peers, but this is not a major rating factor as OCC operates as a utility for its members and focuses more on cost recovery than on profit maximization.

Standard & Poor's base-case operating scenario

- We believe options volumes cleared at OCC will post single-digit growth in 2015, after a 4% increase in 2014 and a 16.8% annual increase, on average, since 1997
- We expect stock lending clearing volumes to keep increasing at a fast pace in 2015, as Basel III regulation provides regulatory capital incentives for banks to have their transactions cleared
- We still expect equity options volumes to provide the lion's share of total volumes cleared at OCC in the next two years

Peer comparison

With its status as a quasi-monopoly, operating as a utility for its member-owners, OCC bears some similarity with U.S. clearinghouses National Securities Clearing Corp. and Fixed Income Clearing Corp. We assess the business position of these three entities as "excellent."

Financial Risk

We assess OCC's financial risk profile as "minimal." The company has no debt apart from $34.8 million of debt on operating leases and $54.2 million on pension deficit (as of end-year 2014). We view $111.7 million of cash on the balance sheet (out of a total of $143.7 million as of year-end 2014) as restricted as it is needed to meet expected regulatory standards (i.e. it corresponds to six months of forward-looking operating expenses). Overall, adjusted debt made up for less than 0.5 times (adjusted) EBITDA, a level that is consistent with a "minimal" financial risk profile.

Financial summary

Table 1

Options Clearing Corp.--Financial Summary			
Industry Sector: Exchanges And Clearing Corporations			
	--Fiscal year ended Dec. 31--		
	2014	**2013**	**2012**
Rating history	AA+/Stable/--	AA+/Stable/--	AA+/Negative/--
(Mil. $)			
Revenues*	305.8	169.1	157.2
EBITDA	131.2	26.2	27.9
Funds from operations (FFO)	63.3	17.4	24.6
Operating income	117.7	14.0	16.2
EBIT	117.7	14.0	16.2
Interest Expense	7.0	6.6	7.0
Net income from continuing operations	64.3	1.6	3.6
Cash flow from operations	63.1	23.6	13.4
Capital expenditures	4.3	10.0	9.5
Free operating cash flow	58.8	13.6	3.9

Table 1

Options Clearing Corp.--Financial Summary (cont.)			
Dividends paid	0.0	0.0	0.0
Discretionary cash flow	58.8	13.6	3.9
Debt	57.0	96.3	101.3
Equity	97.1	25.4	11.6
Debt and equity	154.1	121.7	112.9
Adjusted ratios			
Annual revenue growth (%)	80.8	7.6	4.6
EBITDA margin (%)	42.9	15.5	17.8
EBIT margin (%)	38.5	8.3	10.3
EBITDA interest coverage (x)	18.9	4.0	4.0
Debt/EBITDA (x)	0.4	3.7	3.6
FFO/debt (%)	111.1	18.1	24.3
Free operating cash flow/debt (%)	103.2	14.1	3.9

*Revenues after refunds.

Preliminary Anchor

OCC has an "excellent" business risk profile and "minimal" financial risk, resulting in a 'aa+'/'aaa' anchor. We have chosen the lowest of the two possible preliminary anchors for two reasons:

- A default of the U.S. sovereign (AA+/Stable/A-1+) on its debt would pose serious challenges for the company because of OCC's reliance on U.S. Treasury bonds posted as margins by clearing participants
- OCC has lower profitability than peers, which is not reflected in the business position (given the quasi-monopolistic status)

Clearing And Settlement Risk

We view the quality of membership at OCC as "average," representative of the U.S. financial industry, with some concentration on the largest five clearing members.

OCC raised $150 million from shareholder exchanges in March 2015. The capital contribution, combined with 2014 earnings (net of a $33 million member refund), allowed OCC to reach a total capital of $247 million (from $25 million in 2014), a level that is now sufficient to cover six months of expenses plus an amount that the Board approved to cover foreseeable operational, market, and business risk. Shareholders have also agreed to a replenishment capital commitment of up to $200 million (if needed). With these important changes, OCC is now fully compliant with the Committee on Payment and Settlement Systems and the Technical Committee Of the International Organization of Securities Commissions principles. We also expect OCC to comply with the proposed (but not yet implemented) SEC Covered Clearing Agency rules on minimum capital requirements.

We view OCC's margining system as sound, despite the relative concentration on the largest five members. This reflects the following elements:

- The introduction in 2014 of concentration limits for some types of collateral posted as margins (such as stocks).
- The assumption of a two-day close-out period for options and futures positions, which we believe is commensurate with the liquidity of these derivatives markets in the U.S
- Our understanding that OCC will introduce further positive enhancements in 2015, such as incorporating volatility risk factors for short-dated options, and introducing a liquidation surcharge accounting for costs corresponding to a liquidation of the portfolio.
- Our understanding that cross-margining arrangements with the CME Group Inc. (CME) and Intercontinental Exchange Inc. (ICE) remain limited for now. OCC is engaged in agreements with the CME and ICE whereby clearing members can benefit from cross-margining between their "house" index options positions and their "house" futures positions on the same underlying at the CME (for the S&P Index suite) or at ICE (for the Russell-Index suite). Margins on cross-margined positions are held in joint accounts with CME and ICE, and clearing losses would be split 50/50 between the interested parties (should they materialize). For now, such cross-margining arrangements apply to a maximum of 5% of total OCC revenues.

On top of initial and variation margins, OCC collects clearing fund contributions from members. OCC has the possibility to re-size the clearing fund intra-month in order to capture the most recent volatility trends, which the $1.8 billion increase the company made in mid-October 2014 demonstrates. The total size of the clearing fund was $8.3 billion as of end-year 2014, representing about 8% of total margins posted by members.

OCC lacks the pool of liquidity resources that would enable it to settle, at a 99% confidence level, the securities transactions of the largest two clearing members (should they default at the same time). This is in contrast to the "cover 2" minimum standard that European peers must meet. Liquidity issues could arise, for example, if a clearing member defaults right before the options expiration date (for options contracts that settle in cash, like the SPX Contract on the S&P 500 Index). However, OCC has recently entered into a new credit facility agreement with a nonbank for $1 billion. This adds up to the part of the clearing fund contributions that are paid in cash and to the $2 billion bank syndicated credit facility that, combined, constitute liquid resources that the company could use to settle securities transactions of the defaulted clearing members. OCC could proceed to additional margin calls--or request specific members increase the cash component of clearing fund contributions--should the company perceive that a specific member poses liquidity risk in case it defaults. Overall, we view OCC as a strong "cover 1," consistent with the regulatory obligations applicable to the company.

Table 2

Clearing Risk Metrics--Options Clearing Corp.	
As of year-end 2014	
Number of members (CM)	115
Margins	
Total margin deposited (IM, bil. $)	106.3
Total required margins (bil. $)	46.2
Confidence level (%)	99.00
At risk / close-out period	2 days
Margin concentration	Top 5 = 33.3%; Top 10 = 53.5%
Type of collateral eligible for margins	Specific deposits (underlying securities to short equity calls), valued securities, letters of credit (LOCs), U.S. Treasury securities, government-sponsored debt (GSE), money market funds (MMF), cash, escrow deposits (on short index/equity call and put options).

Table 2

Clearing Risk Metrics--Options Clearing Corp. (cont.)	
General approach for computing margins	STANS for all accounts, SPAN for customer segregated futures accounts, for those accounts the higher of the two calculations apply.
Margin calculation level	Net margin for securities customers (omnibus customers), proprietary and market maker accounts. Customer gross margin for segregated futures accounts, including professional customer cross-margin accounts.
Guarantee Funds	
What does the guarantee fund intend to cover?	The idiosyncratic default by the largest clearing member group (CM), with 99% confidence. A minor systemic event involving the near-simultaneous default of two randomly chosen CMs, with 99.9% confidence.
General approach for calibrating the size of the guaranty funds	Stress-based approach
Total guaranty funds contributions (GF, bil. $)	8.3
Type of collateral eligible for clearing fund contributions	Cash, U.S. Treasury securities and Canadian government securities.
Skin in the game	No
Assessment powers	1 time the required guarantee fund
Waterfall order	1. Margin deposits of defaulter 2. Clearing Fund deposits of defaulter 3. Clearing fund deposits of nondefaulting members.
Liquidity sources	
Access to central bank	No
Committed lines of credit (bil. $)	3.0
What do the sources of liquidity intend to cover?	Cover 1 at a 99% confidence level
Recovery / Resolution mechanisms (e.g. contracts tear-ups, variation margins haircutting)	Full tear up- close out netting
Default experience	The guarantee fund has been used once (to close out the positions of a broker in October 1987)

Liquidity

The "exceptional" assessment reflects our projection that sources of liquidity (mostly cash flow from operations) would exceed uses of liquidity (mostly capital expenditures of about $8 million per year) by at least two times in the next two years. In a stress scenario in which EBITDA falls by 50%, we believe the company would still have excess cash.

Principal liquidity sources

- $32 million of unrestricted cash
- About $60 million of cash flow from operations a year

Principal liquidity uses

- About $8 million of capital expenditures per year

Rating Score Snapshot

Issuer Credit Rating: AA+/Stable/--

Business risk: Excellent (1)

- Country risk: Very Low (1)
- Industry risk: Low (2)
- Competitive position: Excellent (1)

Financial risk: Minimal (1)

- Cash flow/Leverage: N/A

Preliminary anchor: aa+

Clearing and settlement risk: 0

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Exceptional (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile/group credit profile: aa+

Reconciliation

Table 3

Reconciliation Of Options Clearing Corp. Reported Amounts With Standard & Poor's Adjusted Amounts

	--Fiscal year ended Dec. 31, 2014--							
(Mil. $)								
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**
Reported	--	97.1	305.8	115.0	109.1	--	115.0	57.4
Standard & Poor's adjustments								
Current tax expense (reported)	--	--	--	--	--	--	(61.9)	--
Operating leases	34.8	--	--	10.1	2.5	2.5	7.6	7.6
Postretirement benefit obligations/deferred compensation	54.2	--	--	6.1	6.1	4.4	2.7	(1.9)
Surplus cash	(32.0)	--	--	--	--	--	--	--

Table 3

Reconciliation Of Options Clearing Corp. Reported Amounts With Standard & Poor's Adjusted Amounts (cont.)								
Total adjustments	**57.0**	**0.0**	**0.0**	**16.2**	**8.6**	**7.0**	**(51.6)**	**5.7**
Standard & Poor's adjusted amounts								
	Debt	**Equity**	**Revenues**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**
Adjusted	57.0	97.1	305.8	131.2	117.7	7.0	63.3	63.1

Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For Financial Market Infrastructure Companies, Dec. 9, 2014
- Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies, Dec. 9, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Related Research

- 2015 Global Financial Market Infrastructure Companies Outlook: Continuing To Adapt To A Challenging Operating Environment, Jan. 26, 2015
- Rating Factor Assessments For Global Financial Market Infrastructure Companies (December 2014), Dec. 12, 2014
- Standard & Poor's Applies Its Revised Criteria For Global Financial Market Infrastructure Companies, Dec. 11, 2014

Ratings Detail (As Of May 20, 2015)		
Options Clearing Corp.		
Counterparty Credit Rating		AA+/Stable/--
Counterparty Credit Ratings History		
10-Jun-2013	*Foreign Currency*	AA+/Stable/--
08-Aug-2011		AA+/Negative/--
15-Jul-2011		AAA/Watch Neg/--
19-Apr-2011		AAA/Negative/--
10-Jun-2013	*Local Currency*	AA+/Stable/--
08-Aug-2011		AA+/Negative/--
15-Jul-2011		AAA/Watch Neg/--
19-Apr-2011		AAA/Negative/--
Sovereign Rating		
United States of America		AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.