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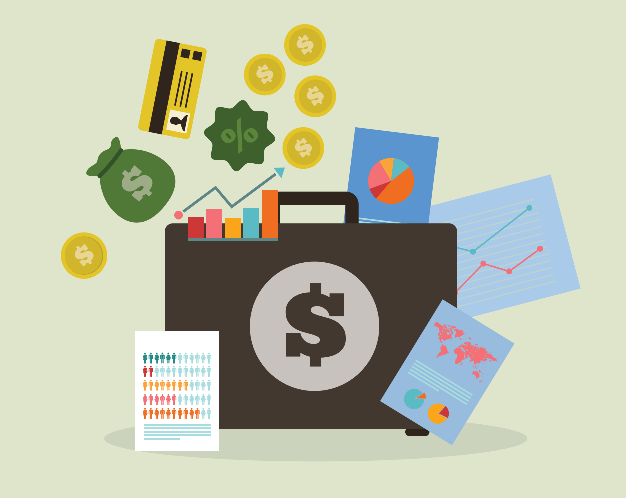
Making the Case for Smarter Regulation of Centrally Cleared Markets

By, Craig Donohue, Executive Chairman & CEO, OCC

Centrally cleared, exchanged-traded derivatives markets have flourished over the last several decades. Under substantial regulation at all critical points (i.e. brokers, clearing members, exchanges and central counterparties (CCPs)), these markets proved to be resilient during the 2008 financial crisis. The regulatory regime for these markets included requirements respecting record-keeping, price reporting and transparency, and intermediated access to CCPs like OCC. Providing independent risk management of financial transactions under the regulatory oversight of the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC), OCC has served as the foundation for secure markets in the U.S. listed equity options markets since 1973.

Following the 2008 financial crisis, global policymakers borrowed the key tenets of these markets in mandating regulatory reform of the over-the-counter (OTC) derivatives markets. To date, neither the G20 reforms nor the new capital requirements for important financial market participants—particularly, the Basel III regime that covers banks and their affiliated entities—are fully implemented. Yet, international policymakers have already started efforts to re-write the rules that underpin the regulatory framework for CCPs such as OCC in "guidance" issued by the International Organization of Securities Commissions (IOSCO) earlier this summer.

OCC supported the enhanced regulatory requirements imposed on CCPs in conjunction with OTC regulatory reform. This includes requirements that expanded our compliance obligations, increased the amount of day-to-day oversight and scrutiny by policymakers, and raised the cost of doing business in our markets. We are seriously concerned, however, that repeated cycles of new and overly prescriptive regulation of centrally cleared markets will undermine the core objective of OTC regulatory reform: mandating the use of CCPs for standardized OTC derivatives products and financially incentivizing the use of CCPs in markets where there is no mandate to centrally clear such OTC derivatives.



The incredibly prescriptive nature of the new IOSCO "guidance" poses model and contagion risk for cleared markets globally by, for example, attempting to create uniform stress testing and risk management requirements for all CCPs. IOSCO's new approach would eliminate virtually any discretion that a CCP currently possesses to tailor its risk management framework to the business and the services it provides. This interferes with a CCP's ability to continue to successfully manage its unique credit, liquidity, operational and business risks. Moreover, the cost of capital to support cleared and regulated derivatives markets stands to cut off access to CCPs, increase concentration risk among intermediaries and markets, eliminate incentives to use cleared markets and drive banks to riskier markets that provide a better return-on-equity.

Recent data supports that we are on the verge of this pendulum swing.A working paper by the Office of Financial Research (OFR) titled "Does OTC Derivatives Reform Incentivize Central Clearing?" shows that the cost comparison of cleared versus bilateral derivatives "does not necessarily favor central clearing and, when it does, the incentive may be driven by questionable differences in CCPs' default waterfall resources." Of significance is that the OFR paper did not consider the relative costs once the leverage ratio requirements are implemented. As discussed in a recent paper by Darrell Duffie, over-simplified approaches to bank capital models such as the new leverage requirement, which treats all assets as though equally risky, drives "balance-sheet management of some of the largest banks to be determined in significant part by these new requirements. This has implied a shift by some large banks away from low-risk low-profit intermediation." Banks and bank affiliates must comply with the leverage ratio requirement in 2018. We should expect to see capital requirements for centrally cleared markets increase with the implementation of the leverage ratio and further elimination of any incentives to clear OTC derivatives.

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Craig Donohue

This also is supported by anecdotal evidence that banks are reducing the capital they allocate to market making and agency services in the U.S. listed equity options markets. We've heard the business case to deploy capital to support client clearing and market making activity in equity options markets is becoming more challenging and may force certain entities to exit the client-clearing business altogether unless policymakers clarify soon that banks and bank affiliates may delta adjust their notional exposures and offset certain risk exposures within a portfolio for market marking activity in the U.S. listed equity options markets. Providing certainty to banks that they may calculate their capital requirements for listed U.S. equity options portfolios is consistent with the SEC's net capital rules and the Standardized Approach for measuring counterparty credit risk exposures (SA-CCR), the latter of which was supposed to be adopted by U.S. policymakers in January 2017. Providing such certainty also would preserve incentives for banks and bank affiliates to deploy capital to centrally cleared markets and continue to facilitate client access to these markets.

The unintended, adverse consequences of overly prescriptive regulations on CCPs and exorbitant capital requirements for banks in light of the risk of listed U.S. equity options products will be increased systemic risk and disruption to the use and continued growth of these important financial markets.

So, let's hit the pause button on the current efforts to re-regulate centrally cleared, exchange-traded markets. Let's do a holistic assessment with a robust cost/benefit analysis, to ensure efforts to prevent the next financial crisis are not actually fueling it. Let's take appropriate corrective action to address identified problems. I am not advocating for de-regulation of centrally cleared, exchange-traded markets or a return to a pre-2008 regulatory and capital regime. Instead, I am advocating for smarter regulation. CM