BANK CAPITAL REGULATIONS ARE ADVERSELY IMPACTING THE OPTIONS MARKET

Recently implemented regulatory capital rules governing banking organizations are inadvertently dampening liquidity in the options market because they do not take into account the risk reducing characteristics of options and instead impose unnecessarily inflated capital requirements for option positions that can be riskless or risk reducing. A simple solution is available.

Issue: Regulatory Capital Rules Governing Banking Organizations

The Basel Committee on Banking Supervision (Basel Committee) consists of senior representatives of bank supervisory authorities and central banks from many of the major financial jurisdictions, including the U.S. The Basel Committee adopted a framework to reduce systemic market risk by requiring banks to increase capital and/or decrease leverage for certain risk exposures (Basel III). The Office of the Comptroller of the Currency and Board of Governors of the Federal Reserve System have adopted rules in order to implement various aspects of Basel III in the U.S., including the manner in which Risk-Weighted Assets (RWA) are calculated. Unfortunately, current requirements obligate large U.S. bank holding companies to calculate their RWA using a standardized approach known as the Current Exposure Method (CEM). Under CEM, options risk is measured by notional amount, and the actual risk of exposure to option positions is ignored. For example, CEM fails to recognize that an option that is far out-of-the money will have a very low delta value (i.e., the option's value is less sensitive to changes in the value of the underlying security or index). CEM also fails to properly allow offsetting risks to be netted (i.e., offsetting of positions) when calculating capital charges.

Although the Basel Committee agreed to replace CEM by January 2017 with a more risk-sensitive method known as the Standardized Approach for measuring Counterparty Credit Risk exposures (SA-CCR), the Board of Governors of the Federal Reserve has not yet implemented SA-CCR, and the transition is not imminent. The effect is that CEM grossly overstates a bank's actual economic exposure to listed option positions, which requires banking organizations to hold capital that is disproportionate to the actual risks posed by the option positions, including via a bank-owned clearing firm's listed options business. This problem is especially acute in high notional value products like CBOE's S&P 500 Index options.

Impact: Bank-Owned Clearing Firms Clear the Majority of Market-Maker Transactions

All listed options transactions in the U.S. are cleared at the Options Clearing Corporation (OCC). The OCC is comprised of clearing members that effectively guarantee the performance of the parties to an options transaction. Option market-makers on exchanges like CBOE clear their trades through OCC clearing members. The vast majority of these clearing members are subsidiaries of bank-holding companies that are now subject to option-insensitive capital requirements that govern the method by which banking organizations calculate capital charges and affect the amount of capital the banking organizations must maintain.

Regulatory Capital Rules Unintentionally Harm the Listed Options Market

Current regulatory capital rules are not properly calibrated because they are not sufficiently risk sensitive. The regulatory capital rules fail to account for an option's delta and fail to fully recognize the offsetting of positions with opposite economic exposure (i.e., long positions and short positions). The gross overstatement of a bank's actual economic exposure requires banking organizations to hold capital that is disproportionate to the actual risks posed by a bank-owned clearing firm's listed options business. Thus, bank holding companies are increasingly less willing to maintain the capital necessary to allow their affiliates to clear options transactions. *The immediate effect is that bank affiliated clearing firms are now instructing market-makers to curtail their options trading activity in order to reduce the bank affiliated clearing firm's regulatory capital footprint. This reduces liquidity in the options market to the detriment of investors.*

Market-Makers are Critical to the Options Market

In the listed options market, liquidity is supplied by professional market-makers. Most investor orders are executed against market-maker quotations. Due in part to the dispersion of trading interest across hundreds of options series in a single options class, the majority of individual options series would have no posted liquidity if options market-makers were not present. In short, market-maker liquidity provision is critical to vibrant option markets, which is why the impact of detrimental bank capital regulations on market-maker liquidity is so concerning to CBOE.

Options are Important Risk Mitigation Tools

Options are first and foremost incredibly useful and powerful risk mitigation tools that can help protect an investor's financial portfolio. From buying puts to hedge the downside risk of owning a stock to writing covered calls to collect income and cap potential losses, listed options strategies are protective tools employed by institutions, pension funds, and individual investors. Importantly, option positions can offset one-another and curtail risk. More option positions should not necessarily equate to higher capital requirements – options used in combination often reduce risk and should thereby reduce a capital requirement--not increase it.

We Need a Solution

Market-maker liquidity is the backbone of the options industry. A regulatory capital regime that unintentionally causes market-makers to limit their options trading activity will reduce liquidity to the detriment of all options users, including individual investors.

CBOE stands ready to work with interested parties on a meaningful solution which could include:

- Interpretive relief from the Board of Governors of the Federal Reserve that will allow bank-owned clearing members to apply a more risk-sensitive methodology to listed options.
- Adoption of SA-CCR: Although the members of the Basel Committee, including the U.S., agreed to adopt the more risk-sensitive RWA calculation method knows as SA-CCR by January 2017, the United States has not yet implemented SA-CCR and is not close to implementing SA-CCR.
- Legislation that properly identifies the risk profile of listed options.