115TH CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPORT
115–810

OPTIONS MARKETS STABILITY ACT

JULY 10, 2018.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. HENSARLING, from the Committee on Financial Services, submitted the following

R E P O R T

[To accompany H.R. 5749]

The Committee on Financial Services, to whom was referred the bill (H.R. 5749) to require the appropriate Federal banking agencies to increase the risk-sensitivity of the capital treatment of certain centrally cleared options, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike all after the enacting clause and insert the following:

SECTION 1. SHORT TITLE.

This Act may be cited as the "Options Markets Stability Act".

SECTION 2. RULEMAKING.

Within 180 days of the date of enactment of this Act, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency shall, jointly, issue a proposed rule, and finalize such rule within 360 days of the date of enactment of this Act, to adopt a methodology for calculating the counterparty credit risk exposure, at default, of a depository institution, depository institution holding company, or affiliate thereof to a client arising from a guarantee provided by the depository institution, depository institution holding company, or affiliate thereof to a central counterparty in respect of the client's performance under a derivative contract cleared through that central counterparty pursuant to the risk-based and leverage-based capital rules applicable to depository institutions and depository institution holding companies under parts 3, 217, and 324 of title 12, Code of Federal Regulations. In issuing such rule, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency shall consider—

(1) the availability of liquidity provided by market makers during times of high volatility in the capital markets;

(2) the spread between the bid and the quote offered by market makers;

(3) the preference for clearing through central counterparties;

(4) the safety and soundness of the financial system and financial stability, including the benefits of central clearing;

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(5) the safety and soundness of individual institutions that may centrally clear derivatives or options on behalf of a client, including concentration of market share;

(6) the economic value of delta weighting a counterparty's position and netting of a counterparty's position;

(7) the inherent risk of the positions;

(8) barriers to entry for depository institutions, depository institution holding companies, affiliates thereof, and entities not affiliated with a depository institution or depository institution holding company to centrally clear derivatives or options on behalf of market makers;

(9) the impact any changes may have on the broader capital regime and aggregate capital in the system; and

(10) consideration of other potential factors that impact market making in the options market, including changes in market structure.

SEC. 3. REPORT TO CONGRESS.

At the end of the 5-year period beginning on the date the final rule is issued under section 1, the Board of Governors of the Federal Reserve System shall submit to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate a report detailing the impact of the final rule during such period on the factors described under paragraphs (1) through (10) of section 2.

PURPOSE AND SUMMARY

On May 10, 2018, Representative Randy Hultgren introduced H.R. 5749, the "Options Markets Stability Act". The bill, as modified by an amendment in the nature of a substitute offered by Representative Bill Foster, directs the Federal Reserve, the Federal Deposit Insurance Company (FDIC), and the Comptroller of the Currency (OCC) to issue a proposed rule, and to finalize such rule within 360 days of enactment, to adopt a methodology for calculating the counterparty credit risk exposure under derivative contracts pursuant to risk-based and leverage-based capital rules.

BACKGROUND AND NEED FOR LEGISLATION

In response to the 2008 financial crisis, the Basel Committee on Banking Supervision (Basel Committee) agreed to modify internationally negotiated bank regulatory standards known as the Basel Accords to increase bank capital requirements. On July 9, 2013, the federal banking regulators, including the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), issued a final rule to implement most of the Basel III recommendations.

In addition to raising the simple leverage ratio, Basel III established a "supplementary leverage ratio" (SLR) that requires certain larger banking organizations to include leverage exposures that are both on and off the bank's balance sheet, which includes exposures arising from futures, options, and other derivative transactions. The SLR was intended to be "a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to risk-based capital requirements." All banks with at least $250 billion in total assets and $10 billion in foreign assets must meet an SLR of 3 percent. Banks subject to these rules were required to meet the SLR beginning in January 2018.

Under Title VII of Dodd-Frank, certain over-the-counter (OTC) swaps were required to be centrally cleared in order to take advantage of the risk mitigating benefits of clearing. As a result, the role of clearing members and the amount of transactions cleared by these institutions has expanded significantly. However, businesses

and end-users that use futures and swaps to manage business risks can only trade cleared derivatives through a clearing member, as they cannot access clearinghouses directly.

Recently, in its October 6, 2017 Report on Capital Markets, issued pursuant to President Trump's February 3, 2017 Executive Order, the Department of Treasury identified the SLR as a risk-insensitive capital rule that is discouraging central clearing and increasing costs to customers. The Treasury's report noted two particular problems with the SLR. The first—the treatment of initial margin—is addressed by H.R. 4659. The second problem—the current approach for calculating exposure for cleared options—is addressed by H.R. 5749.

Under the Basel III rules, banks are required to calculate charges for cleared options using the standardized approach known as the Current Exposure Method ("CEM"). CEM is not properly calibrated for options because it is not sufficiently risk-sensitive, resulting in higher leverage ratio capital requirements for certain derivatives products (including exchange-traded derivatives) relative to risk-based measures. The CEM model, for example, requires options contracts to be sized on their notional face value rather than allowing for a risk adjustment to notional to reflect the actual exposure associated with these derivatives. Specifically, CEM does not permit a delta adjustment for the notional value measurement of options. Implementing a rule that would allow for a more risk-adjusted approach to value centrally-cleared options as it relates to capital rules will better and more accurately reflect exposure and promote options market-marking activity. As IOSCO (the International Organization of Securities Commissions) noted the importance of market making in a May 1999 paper, "The market maker in general adds to the stability, liquidity and transparency (i.e. price discovery mechanism) of financial markets."

Moreover, the CEM measures exposures on a gross basis and is, therefore, overly restrictive in permitting netting and the offsetting of long and short positions. Typically, for example, market makers and others who maintain hedged positions will execute and clear offsetting trades. When done through the same Central Counterparty (CCP), the risk of such hedged positions is reduced, or even eliminated. The CEM, however, applies separately—on a gross basis—to each of the offsetting positions, compounding the capital that hedged traders' Futures Commissions Merchants (FCMs) must set aside, even though the hedged position has reduced exposure overall. By contrast, a trader with an unhedged, directional position—by definition more risky than a hedged position—will, from a CEM perspective, have less exposure than a hedger with two offsetting trades. Modernizing this calculation will incentivize the use of hedged positions, reduce the amount of capital required to place those positions, and reduce overall risk exposure.

Options have sensitivity to the price of the underlying stock, such that at any given point in time, the value of an option will respond differently to changes in the price of the option's underlying shares. This market sensitivity is referred to as an option's delta. The CEM fails to account for the delta of options and fails to fully recognize the offsetting of positions with opposite economic exposure—i.e., long positions and short positions. Thus, the CEM

requires banking organizations to hold capital that is disproportionate to the actual risks posed by a bank-owned clearing firm's listed options business. Accordingly, the CEM constrains the ability of options market-makers to accumulate positions (even offsetting positions), which hinders their ability to provide liquidity. The knock-on effects are increased costs to investors, heightened possibility of market dislocation during volatile environments, and the discouragement of centrally-cleared products that help limit systemic risk.

To remedy these problems, H.R. 5749, as amended, will require the Federal Reserve Board, the OCC, and the FDIC to issue a proposed rule to adopt a methodology for calculating the counterparty credit risk exposure under exchange-listed derivative contracts pursuant to risk-based and leverage-based capital rules. In devising such methodology, the banking regulators shall consider, among other things, the availability of liquidity provided by market makers during a period of high volatility, spreads between bids and quotes, the preference for central clearing, the safety and stability of the financial system and clearing institutions, the benefits of central clearing, and the inherent risk of the positions.

The bill also requires the banking regulators to consider the economic value of an offset using "delta weighting" and "netting" of correlated positions in the calculation. Delta weighting takes into account the price sensitivity of a derivative relative to changes in the price of the underlying asset and is the number of points than an option's price is expected to move for each one-point change in the underlying asset. Delta provides an indication of how the option's value will change with respect to price fluctuations in the underlying instrument, assuming all other variables remain the same. Netting acknowledges that counterparties may have correlated positions where one party is long and another is short on a specific position. Both of these policy changes can be found in the Basel Committee on Banking Supervision's "Standardized Approach for Counterparty Credit Risk Exposures" (SACCR), a more risk-sensitive method. The Basel Committee agreed to replace CEM with SACCR by January 2017, but the transition to SACCR is not imminent in the United States.

HEARINGS

The Subcommittee on Capital Markets, Securities, and Investments held a hearing examining matters relating to H.R. 5749 on February 14, 2018.

COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on June 14. 2018, and ordered H.R. 5749 to be reported favorably to the House as amended by a recorded vote of 54 yeas to 0 nays (recorded vote no. FC–188), a quorum being present. Before the motion to report was offered, the Committee adopted an amendment in the nature of a substitute offered by Mr. Foster by voice vote.

COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion

to report legislation and amendments thereto. The sole recorded vote was on a motion by Chairman Hensarling to report the bill favorably to the House as amended by a recorded vote of 54 yeas to 0 nays (recorded vote no. FC–188) a quorum being present.

Record vote no. FC-188

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Hensarling	X			Ms. Maxine Waters (CA)	X		
Mr. McHenry				Mrs. Carolyn B. Maloney (NY)	X		
Mr. King	X			Ms. Velázquez	X		
Mr. Royce (CA)	X			Mr. Sherman	X		
Mr. Lucas	X			Mr. Meeks	X		
Mr. Pearce	X			Mr. Capuano	X		
Mr. Posey	X			Mr. Clay	X		
Mr. Luetkemeyer	X			Mr. Lynch	X		
Mr. Huizenga	X			Mr. David Scott (GA)	X		
Mr. Duffy	X			Mr. Al Green (TX)	X		
Mr. Stivers	X			Mr. Cleaver	X		
Mr. Hultgren	X			Ms. Moore	X		
Mr. Ross	X			Mr. Ellison			
Mr. Pittenger	X			Mr. Perlmutter	X		
Mrs. Wagner	X			Mr. Himes	X		
Mr. Barr	X			Mr. Foster	X		
Mr. Rothfus	X			Mr. Kildee	X		
Mr. Messer				Mr. Delaney	X		
Mr. Tipton	X			Ms. Sinema	X		
Mr. Williams	X			Mrs. Beatty			
Mr. Poliquin	X			Mr. Heck			
Mrs. Love	X			Mr. Vargas	X		
Mr. Hill	X			Mr. Gottheimer	X		
Mr. Emmer	X			Mr. Gonzalez (TX)	X		
Mr. Zeldin	X			Mr. Crist	X		
Mr. Trott				Mr. Kihuen	X		
Mr. Loudermilk	X						
Mr. Mooney (WV)	X						
Mr. MacArthur	X						
Mr. Davidson	X						
Mr. Budd	X						
Mr. Kustoff (TN)	X						
Ms. Tenney	X						
Mr. Hollingsworth	X						

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the findings and recommendations of the Committee based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee states that H.R. 5749 will incentivize the use of hedged positions and reduce the amount of capital required to place positions and reduce overall exposure within option contracts.

NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

The Committee has not received an estimate of new budget authority contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to Sec. 402 of the Congressional Budget Act of 1974. In compliance with clause 3(c)(2) of rule XIII of the Rules of the House, the Committee opines that H.R. 5749 will not establish any new budget or entitlement authority or create any tax expenditures.

CONGRESSIONAL BUDGET OFFICE ESTIMATES

The cost estimate prepared by the Director of the Congressional Budget Office pursuant to Sec. 402 of the Congressional Budget Act of 1974 was not submitted timely to the Committee.

FEDERAL MANDATES STATEMENT

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995.

The Committee has determined that the bill does not contain Federal mandates on the private sector. The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

ADVISORY COMMITTEE STATEMENT

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of the section 102(b)(3) of the Congressional Accountability Act.

EARMARK IDENTIFICATION

With respect to clause 9 of rule XXI of the Rules of the House of Representatives, the Committee has carefully reviewed the provisions of the bill and states that the provisions of the bill do not contain any congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of the rule.

DUPLICATION OF FEDERAL PROGRAMS

In compliance with clause 3(c)(5) of rule XIII of the Rules of the House of Representatives, the Committee states that no provision of the bill establishes or reauthorizes: (1) a program of the Federal Government known to be duplicative of another Federal program; (2) a program included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public Law 111–139; or (3) a program related to a program identified in the most recent Catalog of Federal Domestic Assistance, published pursuant to the Federal Program Information Act (Pub. L. No. 95–220, as amended by Pub. L. No. 98–169).

DISCLOSURE OF DIRECTED RULEMAKING

Pursuant to section 3(i) of H. Res. 5, (115th Congress), the following statement is made concerning directed rule makings: The Committee estimates that the bill requires a directed rule making within the meaning of such section. Specifically, the bill directs the Federal Reserve, the Federal Deposit Insurance Company (FDIC), and the Comptroller of the Currency (OCC) to issue a proposed rule, and to finalize such rule within 360 days of enactment, to adopt a methodology for calculating the counterparty credit risk exposure under derivative contracts pursuant to risk-based and leverage-based capital rules.

SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 1. Short title

This Section cites H.R. 5749 as the "Options Markets Stability Act".

Section 2. Rulemaking

This section requires the Federal Reserve Board, the OCC, and the FDIC to issue a proposed rule, and to finalize such rule within 360 days of enactment, to adopt a methodology for calculating the counterparty risk exposure under exchange-listed derivative contracts pursuant to risk-based and leverage-based capital rules. It also sets forth issues that should be considered in issuing such rule.

Section 3. Report to Congress

This section requires the Federal Reserve Board to issue a report to Congress—at the end of the 5-year period beginning on the date the final rule is issued—detailing the impact of the final rule during that period on the factors described in section 2.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

H.R. 5749 does not repeal or amend any section of a statute. Therefore, the Office of Legislative Counsel did not prepare the report contemplated by clause 3(e)(1)(B) of rule XIII of the House of Representatives.

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