Angelo Evangelou
Chief Policy Officer

September 7, 2018

VIA ELECTRONIC SUBMISSION

Financial Stability Board
Attn: Mr. Mark Carney
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Basel Committee on Banking Supervision
Attn: Mr. Stefan Ingves
Centralbahnplatz 2
CH-4051 Basel
Switzerland

Committee on Payments and Market Infrastructures
Attn: Mr. Benoît Coeuré
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
Attn: Ms. Patricia Sáenz de Maturana
Calle Oquendo 12
28006 Madrid
Spain

Re: Incentives to centrally clear over-the-counter (OTC) derivatives

Dear Sir/Madam:

The Financial Stability Board, Basel Committee on Banking Supervision, Committee on Payments and Market Infrastructures, and International Organization of Securities Commissions (the "Committees") are in the process of examining whether adequate incentives to centrally clear OTC derivatives are in place. On August 7, 2018, the Committees published a consultative report seeking public comment on their initial findings (the "Report").[1] As a global exchange operator and a leader in exchange-traded derivatives, Cboe Global Markets, Inc. ("Cboe") welcomes the opportunity to provide feedback on the Report and encourages the Committees to not only continue reviewing the effects of post-crisis reforms, but also take concrete steps to remedy issues identified in the Report.

Although the Report focuses on incentives to clear OTC derivatives, many of the issues discussed in the Report are not exclusive to OTC derivatives. Post-crisis reforms have had a significant impact on exchange-traded derivatives markets as well. In particular, **the use of the current exposure method ("CEM") to compute the potential future exposure of exchange-traded derivatives has had significant unintended consequences, such as reducing liquidity, increasing costs to customers,**

[1] *See* FSB, BCBS, CPMI, and IOSCO, *Incentives to Centrally Clear Over-the-Counter (OTC) Derivatives, A post-implementation evaluation of the effects of the G20 financial regulatory reforms*, August 2018, *available at*, http://www.fsb.org/wp-content/uploads/P070818.pdf.

and increasing the possibility of market dislocation. Cboe believes replacing CEM with a methodology that more adequately takes into account the risk profile of derivatives will positively impact both OTC derivatives and exchange-traded derivatives markets without compromising the objectives of the post-crisis reforms.

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As the Report notes, following the global financial crisis G20 Leaders committed to several post-crisis reforms including, among other things, raising capital standards in the international financial system and discouraging excessive leverage. With regards to OTC derivatives markets the architects of the post-crisis reforms committed to centrally clearing standardized OTC derivatives; subjecting uncleared derivatives to higher capital requirements and minimum margin requirements; reporting OTC derivatives to trade repositories; and trading standardized OTC derivatives on exchanges or electronic trading platforms, where appropriate. The main elements of the G20 post-crisis reforms have been agreed to and implementation is largely underway. The Committees now seek to assess whether the relevant reforms are incentivizing central clearing for derivatives dealers and their clients, and the Report provides important conclusions.

Notably, the Report shows that: 1) central clearing of OTC derivatives has increased significantly[2] and 2) the clearing mandate is the main driver of these increases.[3] Based on these findings it is evident that there is a significant incentive to centrally clear particular OTC derivatives, and the incentive is, unsurprisingly, largely related to regulatory requirements mandating central clearance of OTC derivatives. These findings are consistent with the goals of the post-crisis reforms and important to understand when evaluating post-crisis reforms. However, a new concern has emerged—the use of CEM in risk-based and leverage-based capital ratios—which Cboe believes is a disincentive for firms to offer client clearing services in OTC and exchange-traded markets.

Irrespective of the incentives to centrally clear derivatives (of any type), if there are no intermediaries able to offer clearing services to market participants, there will be no central clearing of derivatives. The Report identifies disconcerting trends in this area:

- 68% of client firm respondents reported difficulties in accessing clearing, such as difficulties establishing an account with a client clearing service provider, being declined a new account by an existing provider, or being off-boarded;
- 70% of client firm respondents reported having restrictions placed on their cleared OTC derivatives activity; and
- 94% of client clearing service providers surveyed said they have imposed some sort of restriction on client activity.[4]

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[2] Data on global derivatives markets from the Bank of International Settlements "shows a significant increase in the notional amount outstanding of centrally cleared OTC derivatives since the crisis." *Id*. at 17.
[3] "When survey respondents were asked to rank the factors behind changes in cleared OTC derivatives volumes, the clearing mandate was selected as most important by CCPs, dealers, client clearing service providers and clients alike." *Id*. at 41.
[4] *Id*. at 47-48.

Cboe believes that at this stage in the post-crisis cycle – after significant increases in the amount of OTC derivatives contracts that are centrally cleared and evident deterioration in client clearing services – access to clearing is a critical issue that must now be addressed for both OTC derivatives and exchange-traded derivatives. The Report is instructive in this area as well:

- Client clearing service providers surveyed indicated that the primary reasons clients are off-boarded are constraints caused by one or more of the measures introduced under the Basel III capital framework[5] and
- Over 88% of client clearing service providers surveyed said that the leverage ratio in particular was negatively impacting their ability to provide client clearing services.[6]

In Cboe's experience, it is not only the leverage ratio but also risk-based capital ratios that are causing client clearing service providers to restrict their client clearing activities. Importantly, the utility of the ratios is not the issue; rather, **it is the use of the CEM methodology within these capital ratios that is causing negative outcomes**.

As commenters noted in the Report, CEM's flaws "cause clearing service providers to hold capital well in excess of their estimates of the actual risk" posed by a clients' positions.[7] This occurs, for example, by CEM treating a "deep out-of-the-money strike as equivalent to an at-the-money strike, with no recognition of the former's smaller market risk sensitivity (i.e. lower delta)."[8] This also occurs because CEM fails to fully recognize the offsetting of positions with opposite economic exposures. Requiring a disproportionate amount of capital for a particular risk in turn causes clearing service providers to constrain or eliminate their derivatives clearing services. In both the exchange-listed and OTC derivatives markets this clearing constraint negatively impacts market access and market liquidity. In the exchange-traded derivatives markets in particular this clearing constraint is reducing liquidity, increasing costs to customers, and increasing the likelihood of market dislocation. In the OTC derivatives market this clearing constraint is likely creating a bottleneck effect that is preventing post-crisis OTC derivatives reforms from reaching their full potential.

From Cboe's perspective, the solution is clear. Replacing CEM with a methodology that more accurately accounts for the risk profile of derivatives will remove one of the most significant roadblocks to firms providing client clearing services and will positively affect market liquidity. Notably, the Basel Committee on Banking Supervision has already recognized CEM's flaws and agreed to replace it,[9] and in the interim we believe interpretive relief can be easily and quickly implemented.

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[5] *Id.* at 48.
[6] *Id.* at 63.
[7] *Id*. at 72.
[8] *Id*.
[9] *See* BCBS, The Standardised Approach for Measuring Counterparty Credit Risk Exposures (March 2014)(rev. April 2014), *available at*, https://www.bis.org/publ/bcbs279.htm.

Cboe supports further efforts to study the impacts of post-crisis reforms and as such requests the Committees undertake an additional in-depth study focusing on the incentives to offer clearing services for both OTC derivatives *and* exchange-traded derivatives. Most importantly, Cboe requests the Committees implore standard setting bodies to swiftly replace CEM as the method used to compute the potential future exposure of cleared OTC and exchange-traded derivatives and in so doing correct a known flaw in leverage-based and risk-based capital ratios that will help market liquidity, encourage client clearing, and help G20 Leaders achieve their post-crisis goals.

Sincerely,

Angelo Evangelou

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Chief Policy Officer
Cboe Global Markets, Inc.