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Treasury Market Interagency Working Group Issues Progress Report on Treasury Market Reforms; Annual Treasury Market Conference on November 17 at 9:00 a.m. EDT

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TO: Fixed-Income Advisory Committee RE: Treasury Market Interagency Working Group Issues Progress Report on Treasury Market Reforms; Annual Treasury Market Conference on November 17 at 9:00 a.m. EDT

On November 8, the Inter-Agency Working Group for Treasury Market Surveillance (IAWG) issued a progress report on its efforts to evaluate recent disruptions and potential reforms in the US Treasury market (the "Report").[1] The Report provides an overview of (i) recent stress events in the Treasury market; (ii) six policymaking principles that are guiding the IAWG's work; and (iii) specific policy areas that the IAWG is analyzing to identify steps to strengthen market resilience. We have further summarized the report below.

On Wednesday, November 17 at 9:00 a.m. EDT, the IAWG will convene their seventh annual US Treasury Market Conference to discuss recent Treasury market developments and proposals to improve Treasury market resilience. Featured speakers will include SEC Chair Gary Gensler and Treasury Under Secretary for Domestic Finance Nellie Liang. A copy of the agenda is attached to this memo and a link to the webcast will be made available on the New York Fed's website on the day of the conference.

Recent Disruptions in the Treasury Market

The report highlights the causes behind Treasury market volatility during March 2020 (COVID-19 disruption) and compares this episode with other recent periods of volatility, such as the flash rally of October 2014 and the repo market pressures in September 2019.[2] The IAWG identifies a common theme between these events—sudden surges in trading volumes and demand for intermediation that are not sufficiently met by the supply of market liquidity from dealers. This demand includes both demand for market liquidity as well as funding liquidity. Given that increases in dealer intermediation did not sufficiently absorb this demand for market liquidity and funding liquidity, official sector intervention helped to stabilize the market.

IAWG staff attribute the March 2020 Treasury market disruptions partly to the simultaneous desire among a broad range of investors to raise cash by selling their most liquid non-cash assets, including Treasury securities. These investors included (i) foreign official institutions (e.g., central banks) and private investors; (ii) open-end mutual funds managing redemptions; (iii) real-money investors (e.g., pension funds, insurance companies) rebalancing portfolios between Treasury securities and equities; and (iv) leveraged investors such as hedge funds reducing positions in various assets to comply with risk limits or to unwind cash-futures basis trades. At the same time, demand for Treasury bills increased in part from government money market funds.

The report also highlights several notable challenges to the supply of market liquidity during this time. These challenges included (i) increased risks to markets making for less-capitalized market participants such as principal trading firms; (ii) dealer activity limits despite their increased contributions to trading volume; (iii) the discrepancy between trading circuit breakers that applied in the Treasury futures markets and the lack thereof in the cash Treasury markets, which reduced price discovery and inhibited certain trading strategies; (v) the scarcity of Treasury bills; (vi) increased margin requirements at CCPs and trading platforms, which raised the cost of intermediation; and (vi) operational challenges related to trading caused by a transition to a work-from-home environment.

IAWG Policy Principles and Ongoing Workstreams

The IAWG staff outlined the following six principles that "should guide public policy in the Treasury market":

- Resilient and elastic liquidity
- Transparency that fosters public confidence, fair trading, and a liquid market
- Prices that reflect prevailing and expected economic and financial conditions
- Economic integration across cash, funding, and derivatives markets
- Financing that does not pose a significant threat to financial stability
- Infrastructure that operates effectively and efficiently

Based on these principles, the IAWG has identified several specific policy areas that it is analyzing to identify steps to strengthen Treasury market resilience.

Examining the Effects of Leverage and Fund Liquidity Risk Management Practices

The Report notes that during March 2020, fixed-income open-end funds partly satisfied significant investor withdrawals by liquidating Treasury securities. This liquidation, the IAWG suggests, may have contributed to the stress in the Treasury market. Thus, the IAWG believes that "further study may be warranted to better understand how funds managed their liquidity during the COVID-19 crisis and the effects of fund's actions on the Treasury market."[3] The IAWG also notes that the Financial Stability Oversight Council has established an interagency Open-End Funds Working Group and re-established the Hedge Fund Working Group, both of which will examine and provide relevant policy recommendations, including recommendations to address the activities of hedge funds.

Improving Resilience of Market Intermediation

Some of the potential reforms the IAWG is reviewing related to improving the resiliency of market intermediation include:

- All-to-all trading. Increasing all-to-all trading, which could allow for increased trading directly between non-dealer buyers and sellers and lessen reliance on dealer intermediation.
- Supplementary Leverage Ratio (SLR). Modifying the SLR to potentially allow for increased intermediation capacity for large bank holding companies while ensuring that any changes do not erode the overall strength of bank capital requirements.[4]
- Regulatory congruence. Increasing congruence of regulatory standards across the Treasury market to ensure that regulations applied to non-bank affiliated broker-dealers are sufficiently robust; and aligning methodologies for regulating leverage in the various types of institutions to ensure similar management of risk across the market.

Improving Data Quality and Availability

The IAWG suggests that collecting more detailed and timely data on positions and transactions would enable improvements in market surveillance, oversight, and policy, though it recognized that the costs of any additional data collection must also be carefully considered. With regards to Treasury cash transactions, the IAWG stated that it is exploring whether more information on the positions and flows of domestic investors (beyond the information already captured by TRACE data,[5] the FR2004 report,[6] and Form PF[7]) would provide additional insights into the drivers of episodes of volatility and illiquidity.

The report also notes that pre- and post-trade data is already widely available for Treasury futures, but that there are important gaps in data coverage for Treasury repos, especially for non-centrally cleared bilateral repos, for both the official and private sectors. The IAWG suggests that collecting additional data on non-centrally cleared bilateral repos could enhance the official sector's visibility in this segment, including the nature and extent of leverage. Moreover, the report indicates that there is limited real-time price transparency in the repo market, so collaboration across the official sector on such transparency could help support analysis on this segment of the market. Lastly, the IAWG indicates that additional transparency for the private sector could be considered.

Evaluating Expanded Central Clearing

The IAWG highlighted what it believes to be the potential benefits of expanding central clearing to segments of the Treasury market:

- Standardized, enhanced, and more transparent risk management. A CCP establishes and enforces standardized risk management requirements, such as margins, for the portfolios cleared by its members. To the extent that non-centrally cleared transactions use margins and haircuts based on the low-risk nature of Treasury securities, the margin established by a CCP would likely be more conservative. Additionally, central clearing enhances transparency because a CCP's risk management requirements are disclosed in the CCP's rule book, which is available to regulators and all market participants.
- Balance sheet netting, settlement netting, and trade guarantees. Netting at a CCP could reduce the amount of balance sheet required for intermediation and enhance market-making capacity during both normal times and stress events. By reducing

gross exposures and guaranteeing centrally cleared transactions, a CCP may also reduce the likelihood that small shocks are amplified. Cross-margining between cash and futures markets can also provide balance sheet savings and help net down some exposures.

- Visibility. Central clearing could simplify data collection and improve visibility into market conditions for authorities, and to some degree, for market participants.
- Constituent for additional improvements in market infrastructure. Central clearing could bring about other improvements to market infrastructure such as all-to-all trading, but any changes require further evaluation.

The Report also notes the potential costs of expanded central clearing, which include an increase in the costs of participating in the Treasury market, thereby leading to less intermediation or increased pricing; and a concentration of risk at the CCP. Ultimately, the IAWG suggests that an expansion of central clearing that requires market participants to internalize costs of better risk management can better align participants' incentives and prevent excessive risk taking. Further, the IAWG notes that the potential benefits, costs, and feasibility of expanded central clearing might depend on the differences between the market segments where it is implemented.

Enhancing Trading Venue Transparency and Oversight

The Report highlights the SEC's 2020 proposal to eliminate the exemption from Regulation ATS and apply Regulation SCI to ATSs that trade US government securities, repos, and reverse repos on government securities.[8] The IAWG notes that the SEC is still reviewing all the comment letters on the proposal.

Nhan Nguyen
Assistant General Counsel, Securities Regulation

Nicolas Valderrama
Law Clerk

endnotes

[1] Inter-Agency Working Group for Treasury Market Surveillance, Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report (Nov. 8, 2021) ("IAWG Progress Report"), available at https://home.treasury.gov/system/files/136/IAWG-Treasury-Report.pdf. The IAWG consists of staff from the Treasury Department, the Federal Reserve, the New York Fed, the SEC and the CFTC.

[2] The Report also highlights that in February 2021 large trading volumes attributable to changes in investor sentiment overwhelmed the Treasury market's intermediation capacity. The Report notes that this market stress was exacerbated by liquidity supply issues caused by activity limits that interdealer broker platforms placed on some participants that do not participate in central clearing.

[3] The Report also highlighted that during March 2020, hedge funds were among the

largest sellers of Treasuries, as highly levered positions magnified losses and some funds faced margin calls. The IAWG noted that such sales may have amplified price declines in the Treasury market.

[4] The SLR determines the amount of capital that banks must hold relative to their total leverage exposure.

[5] FINRA collects post-trade transaction data for secondary market Treasury cash transactions through TRACE on behalf of regulators, including data on all transactions where a FINRA member is a counterparty, and releases this data weekly on an aggregated volume basis. See Weekly Treasury volume data from TRACE, available at https://www.finra.org/filingreporting/trace/data/trace-treasury-aggregates.

[6] The New York Fed uses the FR2004 to collect data from primary dealers on weekly holdings by security type and maturity sector.

[7] The SEC uses Form PF to collect quarterly or annual holdings of private funds, such as hedge funds, that are advised by asset managers with at least $150 million in private fund assets under management.

[8] See Securities Exchange Act Release No. 90019 (September 28, 2020), 85 Fed. Reg. 87106 (Dec. 31, 2020). ICI previously submitted a comment letter on the proposal. ICI Memorandum No. 33146 (Mar. 2, 2021), available at https://www.ici.org/memo33146.