

OPINIONS

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For US Treasury Troubles, Treat the Cause Not the Symptom

Regulatory alarm about hidden risk in the Treasury futures market misses the point, fund association execs write.

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Financial regulators in the US have recently expressed worries over the growing use of Treasury futures by registered funds, particularly an increase in long positions over the past three years. These futures positions, in the view of regulators, may be causing vulnerabilities in the US rates market and are therefore a potential source of financial stability risk – one that may need to be addressed. Some regulators have even suggested that the [rise in funds' long futures exposure](#) is being driven by artificial incentives and is costing shareholders, implying further need for regulatory reform.

We believe those assessments are inaccurate. And if regulators want to reduce trading that involves Treasury futures, we caution against policy actions that would treat the symptom rather than the root cause: inefficiencies in the cash Treasury market.

Both long and short positions in Treasury futures are valuable and legitimate tools for funds. For example, they can help asset managers quickly and efficiently adjust their duration and yield curve positioning and better manage credit risk and counterparty risk. And because the futures market can be more liquid than the cash market, Treasury futures can help funds manage their overall liquidity profiles.

Despite those and other practical use cases, growing demand for these instruments has increased concerns among regulators over basis trading – where trading firms such as hedge funds buy Treasury bonds using repo financing, and short Treasury futures. The offsetting long positions in futures are generally held by asset managers. Regulators want to see less basis trading, apparently on the view that if those trades need to be unwound during a crisis, it could lead to heavy sales of Treasury bonds that markets wouldn't easily digest, in turn distorting Treasury bond prices.

If that's the goal, the better approach would be to address the inefficiencies in the cash Treasury market that form the precondition for the basis trade. One possibility, as some regulators have indicated, is to change the [supplementary leverage ratio](#) (SLR), which requires banks to hold (costly) capital at all times against their holdings of Treasury securities and deposits at the Federal Reserve. Such action would help to eliminate the

arbitrage opportunity for the basis trade but still leave a healthy Treasury futures market for risk management and other purposes.

Many observers have commented that the SLR likely added to stresses in the cash Treasury market in March 2020 by raising the costs to dealers of intermediating Treasuries. Indeed, a number of current and former Treasury and Fed officials have for several years indicated that the SLR should be revised in light of the market's [early pandemic experience](#). But nothing has happened yet.

In a [speech](#) this summer before the New York Fed and the European Central Bank, US Treasury undersecretary for domestic finance Nellie Liang suggested [excluding banks' deposits](#) at the Fed from the SLR calculation, perhaps at the discretion of regulators during periods of market stress. That's a step in the right direction, but more can be done.

Both Treasuries and banks' deposits at the Fed should be excluded from the SLR calculation permanently and continuously, rather than temporarily at the discretion of regulators during a crisis. That approach would better enhance the ability of dealers to intermediate during stress periods and lessen market uncertainty on whether SLR relief might be forthcoming amid bond market strains.

Moreover, there are other concrete steps that should be taken to make the cash Treasury market significantly more efficient and liquid.

First, regulators should also exempt directly held Treasuries from the SLR. Second, they should begin to facilitate all-to-all trading in the Treasury market, whereby any market participant could meet and execute trades with any other without having to pass through a dealer. Third, the Securities and Exchange Commission (SEC), which adopted rules last year that will require central clearing of all Treasury repo transactions, should take steps to make it easier for funds and other buy-side actors in the Treasury markets to [unbundle](#) the execution and clearing of these transactions (so-called "done away" trading).

As noted above, regulators have also pointed to the protection of fund shareholders as an area of concern vis-à-vis basis trades. For instance, Liang suggested in her speech that funds are buying Treasury futures rather than actual Treasuries in part because the interest expense of funding Treasury securities through repo is included in fund expense ratios, while the cost of a Treasury derivatives transaction is not.

Neither the Treasury Department nor any other regulatory body has provided evidence for that claim. What's more, ICI's members indicate that investment decisions regarding physical and synthetic Treasuries are based on what is best for a fund. Managers have a fiduciary duty to their clients, including a duty of best execution. If taking a long position in Treasury futures is better or more efficient for a fund and its shareholders than buying Treasury securities directly, or vice versa, that is what the fund's manager will do.

Finally, we urge regulators not to ignore or discount the impact of the comprehensive regulatory frameworks imposed on funds by the SEC and other market regulators.

Registered funds' use of Treasury futures, in addition to their use of repo and reverse repo when trading US government debt, is subject to robust and extensive regulation under the Investment Company Act of 1940 and other securities laws. In 2020, the SEC tightened up the regulatory framework governing registered funds' use of derivatives, including Treasury futures. Under these new [rules](#), unless they only use derivatives to a very limited degree,

funds must adopt a derivatives risk management programme with detailed, enumerated requirements, including an outer limit on fund leverage risk based on the fund's value-at-risk.

The SEC's 2020 rules also allow funds that engage in reverse repo to treat these transactions as derivatives subject to that VAR test or to limit reverse repo and other similar financing transactions to the applicable asset coverage limit under the 1940 Act for senior debt securities. That grants funds additional flexibility to engage in Treasury transactions financed by repos and reduces any potential regulatory incentive to transact Treasury futures instead of physical Treasuries.

Treasury futures deserve attention from regulators, as they have become an important component of cash management strategies and financial markets generally. We hope that regulators draw their conclusions about the reasons for, and implications of, fund managers' use of these instruments by analysing all the facts and avoiding needless speculation.

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