Statement

Treasury Clearing Standards for Membership Requirements and Risk Management

Commissioner Hester M. Peirce

Sept. 14, 2022

Thank you, Mr. Chair. I support today's proposal because it seeks comment on how to address problems we have observed in the Treasury market, not because I necessarily embrace the solution that we are proposing.

Over the past several years, regulators, market participants, and academics alike have devoted increasing attention to the Treasury market. Some of this attention stems from the nature of the market: No market is larger or deeper; none facilitates such a wide range of activities, including effectuating the U.S. government's fiscal, monetary, and regulatory policy, and serving investors' hedging, liquidity, and investment needs. Treasury issuance has exploded in the last two decades; the proposing release notes that the volume of marketable U.S. Treasury securities outstanding has increased by approximately $18 trillion since 2000. Or, as a recent inter-agency report notes, Treasury debt held by the public totaled $5.1 trillion, or 35 percent of 2007's GDP and $21.6 trillion, or 101 percent of 2020's GDP.[1]

The growth in the national debt is concerning for a citizen, but regulators thinking about market quality also quite naturally sit up and take notice. Some of the attention stems from periodic dislocations that are disconcerting in a market of such size, importance, and historic stability. Most recently, for example, in the wake of the COVID-19 outbreak and governmental responses to it, market participants fled *from* rather than *to* the Treasury markets.[2] We cannot write off this market disruption as just another pernicious result of the pandemic and associated government actions. The events of March 2020, although prompted by an unusual set of events, may signal deeper problems in the Treasury market. Indeed, disruptions in this market have become notoriously common, including a flash rally in October 2014 and stress in the repo market in September 2019.

Attention on Treasury markets also comes in response to changes in how the market operates and in the roster of market participants. The Treasury markets have increasingly shifted to electronic trading, which has facilitated greater participation in the market by principal trading firms. These firms use trading strategies and exhibit trading behaviors that can differ significantly from dealers.[3] As the role these firms play in the market has increased and dealer balance sheet space devoted to the Treasury markets has shrunk, the proportion of "interdealer" transactions that are cleared has declined significantly.[4]

Finally, some of the attention on the Treasury market comes from its unique regulatory structure. Congress has allocated oversight of the Treasury market across several different authorities, including the Federal Reserve Board, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, and the Securities and Exchange Commission.[5] Given the fragmentation of oversight, no single regulator can implement a market-wide solution to perceived problems; at the same time,

any significant issue in the market is likely to attract the attention of most or all of these bodies. Translating this attention into coherent policy can be challenging.

In light of the Treasury market's size and recent history of disruptions and change, regulators have a responsibility to examine the market and to devote careful consideration to whether regulatory changes may be warranted. Today's release is the product of careful consideration by the Commission staff. Through its many questions, the release invites the public to further our consideration with comments based on, among other things, the experience and expertise that comes from being in the market. In a moment, I will add some additional questions to the list.

Both regulators and market participants have discussed the possibility that expanded central clearing could help prevent future disruptions by improving and standardizing risk management, netting gross exposures, enhancing transparency, and facilitating further evolution in market structure that could reduce barriers and improve liquidity.[6] As former Commissioner Roisman explained, the rise of electronic trading presents great opportunity for investors, but it also may increase the risk of non-performance by counterparties. He suggested that increased central clearing—and thus increased novation, netting, and guaranteed settlement—could make the market more resilient.[7]

Today's proposal represents one approach to increasing central clearing of Treasury transactions. The proposed rule amendments, if adopted, would effectively require most Treasury transactions into which clearing agency members enter with a large class of counterparties to be cleared. Treasury clearing agencies, of which there is now only one, the Fixed Income Clearing Corporation ("FICC"), would have to calculate, collect, and hold margin from direct participants separately from indirect participants' margin. To accommodate the anticipated increased demand for clearing, the proposal also would require clearing agencies to have policies and procedures to facilitate broader access to clearing and settlement services. Finally, the proposal would amend the broker-dealer customer protection rule to facilitate the posting of customer margin to the clearing agency in connection with Treasury transactions.

The proposal takes a considerably heavier hand to achieve the goal of increased central clearing than seems necessary or desirable. I have several specific questions designed to explore whether we could and should approach the problem with a lighter touch.

- Does the proposal adequately grapple with the complex set of trade-offs associated with central clearing? The proposal seems simply to assume that the more Treasury transactions that are cleared, the better. Any limitations on the reach of the proposed mandate seem driven not by careful considerations of the policy trade-offs but by how far it seems appropriate to extend the membership requirements under our rules. Yes, central clearing can produce significant benefits, including encouraging higher and more transparent risk management standards, netting trades to reduce gross exposures and increase balance sheet capacity, and mutualizing risk in a way that can reduce the contagion risk of firm failure. But central counterparties also can have unpredictable effects on risk: They concentrate risk, which under certain circumstances can increase risks to the market more broadly; they also can transmit risks from a failing firm to other members; they may increase moral hazard; and, through the use of standardized models, they may increase the risk that erroneous models applicable to all participants may present to the market; and, because they generally can make changes to risk management only subject to Commission review and approval, they may decrease flexibility during extreme market events.[8]

- Does the proposal take sufficient account of the potential unintended effects of the proposed clearing mandate? For example, the clearing mandate, if adopted, likely would increase costs of transacting in the Treasury market. Would these higher costs force some participants out of the market, and, if so, what effect would these exits have on liquidity? Perhaps the effects would be more nuanced and more pernicious. For example, perhaps the higher costs of transacting Treasuries instead—or also—make it more likely that some firms that are not clearing agency members would seek out counterparties that also are not clearing members. If so, would more creditworthy firms be able to transact with counterparties that do not trigger the clearing requirement? Would the result be a clearing mandate

that applies disproportionately to transactions between members and firms that are less creditworthy on average and that therefore may present a relatively greater risk to their counterparties and to the clearing agency? Under the clearing access amendment, could the clearing agency feel pressure to prove that it has in place the required access policies by granting easy access to the less creditworthy firms doing business with its members?

- Is FICC able to handle the risk associated with the new transactions it would have to clear if the mandate were adopted? The proposal would increase the size and complexity of FICC's task. Some people assume that regulatory oversight will ensure that the clearing agency manages risk appropriately, but regulators do not always get it right either.

- Would the other proposed amendments (aside from the clearing mandate) shift incentives sufficiently on their own to produce a significant increase in clearing without a mandate? Many market observers agree that increasing the level of central clearing in the Treasury market is desirable, but have cautioned against imposing a mandate, given the difficulty of understanding and balancing the trade-offs of such a requirement. As Marta Chaffee and Sam Schulhofer-Wohl have explained, the changes that would need to be made to make mandatory clearing feasible—changes that include improving access to clearing and modifying customer protection requirements, which are also being proposed today—may themselves improve incentives for central clearing sufficiently to produce some or most of the increase that would be attained by a clearing mandate.[9] Why not start with a less prescriptive approach and move to the mandate only if these other measures prove insufficient?

- Is the Commission overstepping its bounds and encouraging the FICC to overstep its bounds by imposing this requirement as a requirement of membership in FICC? The release argues that members of FICC who do not clear all of their cash or repo Treasury securities transactions "create[] contagion risk to [clearing agencies] clearing and settling in these markets, as well as to the market as a whole" and implies that because increased clearing may ameliorate this risk, it is appropriate to require FICC members to clear even trades with non-members. This reasoning establishes a potentially dangerous precedent for allowing, or requiring, the clearing agency to regulate directly any activity of its members and indirectly the activity of non-members as well. What are the limits of this authority? Could the clearing agency forbid clearing members from entering into transactions with a counterparty whose activities it determines marginally increase the risk the counterparty presents to the clearing agency, such as a hedge fund that does not margin its bilateral trades with counterparties that are not members of the clearinghouse or that invests in both Treasuries and bitcoin?

Thank you in advance to the commenters who will help us to think through the proposal, its potential consequences on the market, and reasonable alternatives. And thank you to the staff in the Divisions of Trading and Markets and Economic and Risk Analysis and Office of the General Counsel for your work on the proposal and your discussions with me about the current state of the Treasury market and the future state we hope the proposal will produce.

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[1] Staffs of the U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, U.S. Securities and Exchange Commission, and U.S. Commodity Futures Trading Commission, Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report at 5 (Nov. 2021), *available at* https://home.treasury.gov/system/files/136/IAWG-Treasury-Report.pdf ("Inter-Agency Working Group for Treasury Market Surveillance ("IAWG") Report").

[2] *See, e.g.*, *id.* at 7-8 ("The disruptions to Treasury markets caught many participants and observers by surprise because they were driven by heavy sales during a period when many had expected a flight to safety to bolster demand for Treasury securities. Typically, demand for Treasury securities increases during market shocks as investors seek to hold safe and liquid assets. However, investors value Treasury securities in part because they are easy to liquidate. In the unique circumstances of the COVID-19 shock, a broad range of

investors wanted to raise cash at the same time and sold their most liquid non-cash assets, often Treasury securities, to do so. . . . Amid these sales, Treasury yields exhibited extreme volatility. . . . The heavy sales demonstrated the potential for sudden, large shifts in investor positioning in the Treasury market. Although trading volumes soared, intermediaries' capacity did not keep up with the selling pressure, and market liquidity deteriorated.").

[3] *Id*. at 5.

[4] *Id* at 5-6.

[5] *See* Yesha Yadav, The Failed Regulation of U.S. Treasury Markets, 121 Colum. L. Rev. 1173, 1193 (2021). Yadav helpfully lays out the complicated web of requirements that apply to financial institutions participating in this market and the confusion that even regulators experience in determining what rules apply to what types of activity in this space. *Id*. at 1193-1199.

[6] *See*, *e.g.*, IAWG Report at 30-31; Futures Industry Association Principal Traders Group, Clearing a Path to a More Resilient Treasury Market (July 2021), *available at* https://www.fia.org/sites/default/files/2021-07/FIA-PTG_Paper_Resilient%20Treasury%20Market_FINAL.pdf; SIFMA, Improving Capacity and Resiliency in US Treasury Markets: Part II Proposals for Reforming US Treasury Markets (Mar. 2021), *available at* https://www.sifma.org/resources/news/improving-capacity-and-resiliency-in-us-treasury-markets-part-2/#_ednref4.

[7] *See* Commissioner Elad L. Roisman, Remarks at U.S. Treasury Market Conference (Sept. 29, 2020), *available at* https://www.sec.gov/news/speech/roisman-us-treasury-conference-2020-09-29.

[8] *See, e.g.,* Hester Peirce, *Derivatives Clearinghouses: Clearing the Way to Failure*, 64 Clev. St. L. Rev. 589, 620-630 (2016).

[9] Marta Chaffee and Sam Schulhofer-Wohl, Is a Treasury Clearing Mandate the Path to Increased Treasury Clearing?, Chicago Fed Insights (June 23, 2021), available at https://www.chicagofed.org/publications/blogs/chicago-fed-insights/2021/treasury-clearing-mandate (arguing that "the changes in the design of the Treasury market necessary to facilitate a clearing mandate could increase clearing even without a mandate").