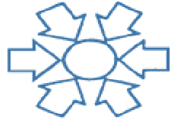

FedFin Client Report

Tuesday, January 5, 2021

FedFin Forecast: Govvie Central Clearing Uncertain, But New Rules for Sure

Client Report: TMARKET

Executive Summary

As we noted earlier (see *Client Report* **REFORM200**), we do not expect U.S. regulators to extend SLR relief (see FSM Report **LEVERAGE23**) after its scheduled March expiration. This is not to say that Treasury and the Fed will leave the Treasury market as is despite the systemic crash that forced central-bank rescue when the COVID crisis hit last year. They know all too well that swelling Treasury issuances will strain market capacity even if renewed systemic stress or idiosyncratic liquidity incidents do not. Both Treasury and the Fed now and under the Biden Administration are also acutely aware that market players are increasingly counting on Fed intervention, a moral-hazard incentive they will seek to stifle as quickly as possible.

In this report, we assess remedies under consideration by U.S. regulators, forecasting action which may well include another late-breaking report from the President's Working Group on Financial Markets. We expect near-term actions to focus not only on the longstanding Treasury/Fed effort to gather better market data, but also on renewed consideration and a decision – likely negative – on whether U.S. regulators can and should mandate central clearing for Treasuries, if voluntary central clearing suffices (unlikely), or -- the most likely outcome -- if still more central clearing leads to still more concentrated systemic risk. In parallel, the Fed will continue to consider establishing a standing-repo facility, but sentiment seems to be shifting against yet another Fed window that makes the central bank still more of an indispensable market maker. Instead, U.S. agencies will look for new ways to promote liquidity through faster work on all-to-all markets, a broker-dealer liquidity facility, and tougher rules on leveraged hedge funds and – less likely – also for principal trading firms. CCP-margin and MMF reform will also advance due to conclusions that weaknesses in these sectors exacerbated the dash for cash instead of just being victims of it.

Analysis

Our forecast for action on options under consideration includes:

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- ***Central Clearing:*** This was extensively discussed after the 2014 flash rally, with then-Gov. Powell leading Fed inquiries. However, Mr. Powell is now ambivalent about central clearing and Vice Chairman Quarles recently said that central clearing likely would not have prevented the March market turmoil (see Client Report **RESCUE78**). Although Gov. Brainard has spoken more favorably of central clearing (see Client Report **SYSTEMIC89**), many questions have arisen about risk concentrations, capital costs, and orderly resolution since central clearing for derivatives was mandated as a crisis fix. As a result, we expect serious consideration of central clearing, but only slow, if any, action as many complexities are weighed and alternative solutions advance.
- ***MMF Reform:*** Much in the FSB report as well as the Fed's most recent financial-stability assessment (see *Client Report* **SYSTEMIC89**) highlight MMF and open-end fund illiquidity and its interaction with Treasury-market volatility. The President's Working Group on Financial Markets late last year (see *Client Report* **MMF16**) went beyond this to conclude that investment funds exacerbated volatility instead of being undermined by it. As a result, U.S. MMF reform will move – and likely quickly – on a separate track from still more complex and thus slower action on Treasury-market resilience.
- ***Stand-by Repo Facility:*** FOMC work will continue on the most frequently-mentioned Fed role in the Treasury market: a stand-by repo facility that would provide market-wide liquidity across the repo market. The last time the FOMC considered this in January, FRB-Philadelphia President Harker said that work was only preliminary, going on to say that the Fed does not want to become the "default" market-liquidity provider or disintermediate markets. The major offsetting benefit of a standing-repo facility is that it would reduce bank reserves and thus the payments made by the Fed in interest on reserves. If Congress renews efforts to limit interest on reserves, then the Fed may be forced to accelerate this new facility, attempting to design it more as a rate floor than as a market-liquidity window to limit the Fed's role not just as central bank, but also as a market-maker.
- ***Leveraged Funds:*** Both the FRB's financial stability report and the FSB's holistic NBFI analysis finger leveraged hedge funds as primary causes of Treasury-market volatility, with the FSB noting also that the bulk of Treasury sales by foreign holders were in fact from leveraged funds domiciled offshore, not foreign central banks. The largest U.S. hedge funds are also the most highly leveraged and thus of scale to cause systemic runs following margin calls for basis traders. A top-priority SEC agenda item will thus be determining the extent to which the Commission can mandate capital or liquidity buffers for large hedge funds or, should this prove uncertain, the extent to which CCP procyclicality reform combined with additional hedge-fund data suffice. FSOC is likely to proceed with a systemic review of both hedge funds and principal trading firms (see below) to determine the extent to which new rules for these entities are possible and, if not, how dealer banks can be regulated to ensure *de facto* margin capacity at their counterparties.
- ***Principal Trading Firms (PTFs):*** We expect FSOC to commence a systemic-designation and/or activity review process for PTFs, first gathering data as the Fed recommends and then assessing ways to ensure that these firms, which have assumed a significant market-intermediation role, can serve as liquidity providers under stress as well as withstand market illiquidity. The extent to which central-clearing is required

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and/or CCP margining reforms advance could offset final designations, but we do not believe PTFs will escape direct or indirect regulatory changes that significantly affect their business model.

- ***Data Collection:*** There remain critical data gaps across nonbank primary dealers and broker-dealers. We expect FSOC quickly to charge the Office of Financial Research with new data-gathering responsibilities, making use of its authority to mandate data filings if voluntary reports are insufficient. The SEC will also work on new PTF and hedge-fund reporting requirements under its jurisdiction.

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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