Wednesday, November 10, 2021

Treasury-Market Reform Construct Leaves Much to Decide, Do

Client Report: TMARKET2

Executive Summary

In this report, we build on our initial analysis of Monday's report from the Inter-Agency Working Group on Treasury Market Surveillance (IAWG). Comprising the Treasury, the Fed, the SEC, the CFTC, and the Federal Reserve Bank of New York, the Working Group's report narrows the scope of reforms to be discussed at next week's closed FSOC meeting and then taken up by both the Group and FSOC. Hints about what staff may think best may be inferred from the report by virtue of where attention is focused and hints about near-term decisions are offered. From this, we infer that central clearing is a top-priority consideration and that all of the agencies support SEC Chairman Gensler's announced plans to bring many broker-dealers in the Treasury sector under SEC authority. Whether this includes bank primary dealers is left unaddressed, but the paper departs from the general construct of global and U.S. agreement that like-kind activities should have like-kind rules, instead saying that all Treasury-market players should be regulated in various respects but how this is done may well need to vary. As we forecast early this year (see *Client Report* **TMARKET**), the report also identifies aspects of the government MMF sector for additional regulation and calls for numerous new data-and-disclosure protocols. Broad MMF reform is left to the ongoing FSOC/SEC-led effort (see *Client Report* **SYSTEMIC92**).

Analysis

Much in the report details how common features (e.g., disintermediation) in the Treasury market led to prior stress events and, even in seemingly-benign conditions, how opacity exacerbates short-term corrections into potentially systemic situations. It is careful to state that its views reflect only staff thinking and thus do not presage official action. However, given that official action is largely premised on staff advice, we view this report as a key policy document. It sets the following principles to guide further action:

- All the facets of the Treasury market should be liquid and elastic via an open market adaptable as rules, market participants, and other factors evolve.
- The market must be transparent with disclosures designed to enhance liquidity and that are backed by effective oversight.

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- Prices should reflect prevailing economic fundamentals, not friction between various Treasury-bond or -bill products. Different entities may be regulated differently.
- Leverage that poses systemic threat should be prevented.
- Infrastructure must be well-designed and efficient.

Workstreams to craft policy options that further these principles address:

- Disintermediation, with this risk likely to grow worse as Treasury issuances increasingly outpace dealer balance-sheet capacity. The report notes only the Fed's new standing facilities which, while designed to enhance monetary-policy transmission, should also stabilize markets under stress;
- Central clearing, off-exchange trading regulation, and/or all-to-all trading, with the paper laying out potential costs and benefits. This detailed analysis suggests, as noted, that this is an area on which the Working Group is particularly focused;
- SLR modification, with the report outlining no specific ways to do so;
- Increased regulatory harmonization across the market focused on broker-dealers that are not bank affiliates, with the report noting ongoing SEC work to require registration for these entities and perhaps all Treasury-market broker-dealers. Work will also consider aligned leverage constraints, with particular attention to hedge funds, MMF resilience in the Treasury-bond arena, and comparable risk management; and
- an array of better data-management and disclosure options.

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