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Treasury Market Regulatory Reforms

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Big changes for the world's largest and most liquid market

The Congressional Budget Office ("CBO") now forecasts that the US public debt will rise from $27.9 trillion dollars at the end of 2023 to $48.3 trillion dollars by 2034.[1] The need to issue more government debt, even as the Federal Reserve pulls back on its Treasury purchase program, could put more strain on the US Treasury market that currently relies on designated broker dealers to not only purchase debt but also provide sufficient liquidity in the primary and secondary markets. The scale of anticipated issuance may outmatch the capacity of broker dealer banks with supplementary leverage ratios ("SLRs") designed to protect banks from liquidity risks.[2] Indeed, higher bond yields, needs for higher levels of government debt issuance, uncertain inflationary pressures, geopolitical risks and higher bond market volatility around the world highlight macroeconomic pressures on the US Treasury market.[3]

The US Treasury market is currently about $26.5 trillion dollars,[4] but its significance to the global financial system is perhaps even greater.[5] The Federal Reserve sets and maintains its monetary policy rates through the Treasury markets.[6] The US government depends on a liquid and resilient Treasury market to issue debt to finance expenditures. Central banks around the world hold Treasuries as part

[1] Source: Congressional Budget Office, "The Budge & Economic Outlook," February 2024.

[2] Source: Securities Industry & Financial Markets Association (SIMFA), P. Ryan "Revisiting US Treasury Market Capacity & Resiliency: Part I; Impact of Rising Debt Levels & Constrained Dealer Capacity on Market Resiliency," December 14, 2023.

[3] Source: Securities Industry & Financial Markets Association (SIMFA), P. Ryan "Revisiting US Treasury Market Capacity & Resiliency: Part I; Impact of Rising Debt Levels & Constrained Dealer Capacity on Market Resiliency," December 14, 2023.

[4] Source: SEC, Chair Gary Gensler, "Statement on Final Rules Regarding Treasury Clearing," December 13, 2023.

[5] Source: US Treasury, Federal Reserve, SEC, CFTC, and FRBNY, Staff Report "Recent Disruptions & Potential Reforms in the US Treasury Market: A Staff Progress Report," November 8, 2021.

[6] Source: Financial Times, K. Duguid, "Radical Changes Coming to the World's Biggest Bond Market," March 3, 2024.

of their capital reserves.(Figure 1) And the yields on US Treasuries form part of the basis for asset prices around the world. The SEC rules which go into effect in December 2025 may help to shore-up the critical Treasury market resiliency and liquidity.

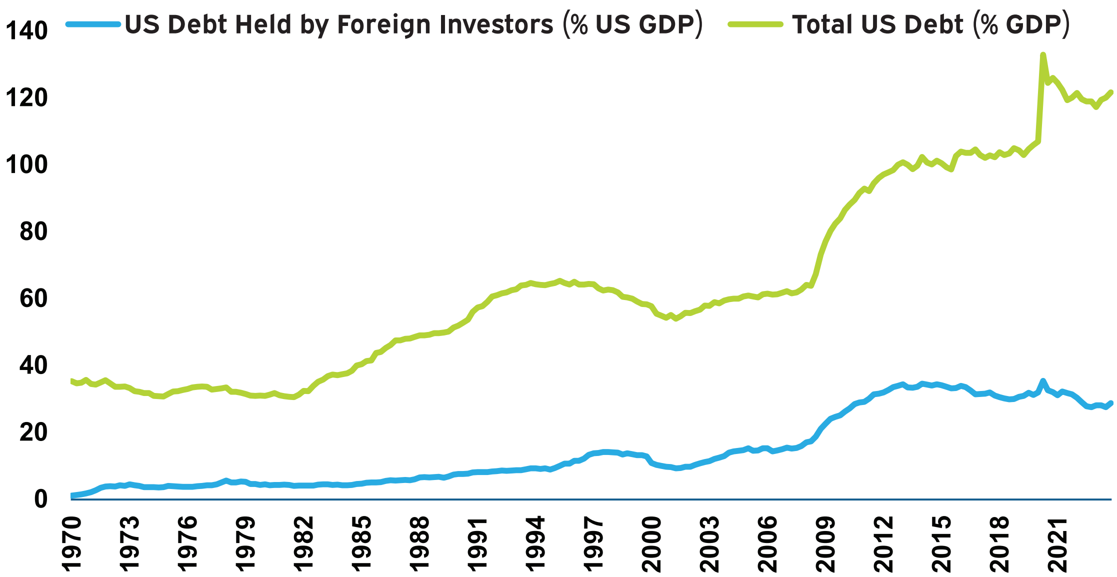

FIGURE 1

Total US Debt & US Debt Held by Foreign Investors (% GDP)

Source: Peterson Institute for International Economics, N. Lardy "Foreign direct investment is exiting China, new data show," November 17 2023. SAFE tracks net FDI while the Ministry of Finance tracks gross inflows.

The Securities and Exchange Commission ("SEC") finalized two new rules for the US Treasury Market. The new rules are part of a wider effort to improve resiliency and liquidity in US Treasury and Repo markets[7] being conducted by the US Treasury, The Federal Reserve, the Federal Reserve Bank of New York ("FRBNY"), the SEC, and the Commodity Futures Trading Commission ("CFTC").[8] The wider reform efforts are focused on more public disclosure of market data and positioning, establishing an expanded and permanent repo facility ("SRF") at the Federal Reserve,[9] removing financing and trading from broker dealers to central clearing trading for Treasuries (newly issued and off-the-run), and a review of bank supplementary leverage ratios (SLR reforms).[10]

Conventional wisdom suggests that the Treasury market is for all intents and purposes is risk free, in reality, there have been three major dislocations of the Treasury market since early 2020, two of which demanded policy support from the Federal Reserve. The March 2020 'dash for cash' saw foreign holdings of US treasuries plummet by $275 billion while at the same time basis-trades often conducted by lightly regulated hedge funds suffered margin calls as their highly leveraged purchases of Treasuries floundered in pandemic related volatility.[11] The March 2020 dash for cash saw the thirty-year treasury bid-offer spread rise to six-times its average spread and the ten-year bond bid-ask spread double.[11] More recently, regional banks suffered from market pressures as their unhedged Treasury holdings pushed Treasury market volatility to highs not seen since the global financial crisis.[12]

[7] Source: Financial Times, K. Duguid, "Radical Changes Coming to the World's Biggest Bond Market," March 3, 2024. Repo market reforms will go into effect in June 2026.

[8] Source: US Treasury, Federal Reserve, SEC, CFTC, and FRBNY, Staff Report "Recent Disruptions & Potential Reforms in the US Treasury Market: A Staff Progress Report," November 8, 2021.

[9] Source: Bloomberg, L. McCormick, "Geithner-Led Group Faults Fed for Slow Work on Treasuries Market," June 30, 2022.

[10] Source: Securities Industry & Financial Markets Association (SIMFA), P. Ryan "Revisiting US Treasury Market Capacity & Resiliency: Part I; Impact of Rising Debt Levels & Constrained Dealer Capacity on Market Resiliency," December 14, 2023.

[11] Source: Financial Times, C. Smith et al., "US Treasuries: The Lesson from March's Meltdown," July 28, 2020.

[12] Source: US Treasury, Federal Reserve, SEC, CFTC, and FRBNY, Staff Report "Recent Disruptions & Potential Reforms in the US Treasury Market: A Staff Progress Report," November 8, 2021.

And in November of 2023, the broker-dealer and Chinese bank , the Industrial & Commercial Bank of China (ICBC)[13] suffered a ransomware attack in it's financial services arm that disabled its market-clearing activities in the Treasury market.[14]

The SEC rules will now shift many Treasury market transactions onto clearing house platforms, instead of direct counterparty trading between broker-dealers, their clients, and investors. Counterparty risks will largely be eliminated by clearing-house rules for pre-approved traders who provide their own cash collateral.[15] "Standing in the middle of the securities markets, clearing houses are the buyer to every seller and seller to every buyer."[15] The clearing house guarantees settlement and delivery of securities and cash collateral ensures liquidity even in case of default. Currently only 13% of the Treasury market is traded in clearing houses.[16] The SEC reforms will move most of the $26.5 trillion dollar Treasury market into clearing houses and away from broker-dealer bank trading books.[17]

Critics of the Treasury market clearing rules cite implementation risks and the potential for higher trading costs.[18]

The regulatory working group may continue to issue new rules and provisions to bolster market liquidity, resiliency, and efficiency but for now the radical reforms in the Treasury market could make the US financial system more resilient and liquid even as the US government looks to issue more debt in the coming decade.

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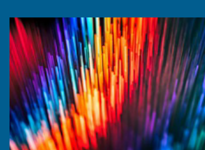

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[13] Source: Financial Times, "Ransomware attack on ICBC Disrupts Trades in US Treasury Market," November 9 2023. Industrial & Commercial Bank of China ("ICBC") Financial Services is a large participant on the Fixed Income Clearing Corporation ("FICC"). The ransomware attack prevented ICBC FS from clearing trades on behalf of market participants that included hedge funds and asset managers that were forced to reroute Treasury and Repo trades. It was unclear if the ransomware hack impacted the 30-year Treasury auction that occurred at the same time where the 30-year bond yield rose 0.12% to 4.78%.

[14] Source: Financial Times, K. Duguid, "Radical Changes Coming to the World's Biggest Bond Market," March 3, 2024. Repo market reforms will go into effect in June 2026.

[15] Source: SEC, Chair Gary Gensler, "Statement on Final Rules Regarding Treasury Clearing," December 13, 2023.

[16] Source: US Treasury, Federal Reserve, SEC, CFTC, and FRBNY, Staff Report "Recent Disruptions & Potential Reforms in the US Treasury Market: A Staff Progress Report," November 8, 2021.

[17] Source: Financial Times, K. Duguid, "Radical Changes Coming to the World's Biggest Bond Market," March 3, 2024. SIMFA has also noted that Basel III bank supplementary lending ratios need to be revisited since banks are currently constrained from providing sufficient liquidity and the clearing rules do not go far enough to ensure resiliency and liquidity.

[18] Source: Securities Industry & Financial Markets Association (SIMFA), P. Ryan "Revisiting US Treasury Market Capacity & Resiliency: Part I; Impact of Rising Debt Levels & Constrained Dealer Capacity on Market Resiliency," December 14, 2023.

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