Clearing a Path to a More Resilient Treasury Market

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CONTENTS

I. EXECUTIVE SUMMARY 3

II. THE BENEFITS OF CENTRAL CLEARING 4

III. THE IMPORTANCE OF A VIABLE CLIENT CLEARING MODEL 7

IV. CONSIDERING A CLEARING MANDATE 11

V. CONCLUSION 12

About FIA PTG

FIA PTG is an association of firms, many of whom are broker-dealers, who trade their own capital on exchanges in futures, options and equities markets worldwide. FIA PTG members engage in manual, automated and hybrid methods of trading, and they are active in a wide variety of asset classes, including equities, fixed income, foreign exchange and commodities. FIA PTG member firms serve as a critical source of liquidity, allowing those who use the markets, including individual investors, to manage their risks and invest effectively. The presence of competitive professional traders contributing to price discovery and the provision of liquidity is a hallmark of well-functioning markets. FIA PTG advocates for open access to markets, transparency and data-driven policy.

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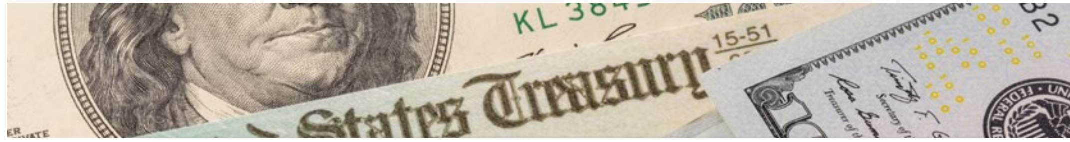

I. EXECUTIVE SUMMARY

The FIA Principal Traders Group ("FIA PTG")[1] has consistently supported central clearing as a policy measure to increase resiliency, liquidity, and transparency in financial markets.[2] We, therefore, welcome the ongoing discussions regarding transitioning more trading activity in U.S. Treasuries (both cash and repo) to central clearing.

Section II details the benefits of increased central clearing, which include alleviating specific balance sheet constraints observed during recent market disruptions, as well as reducing operational risk, facilitating the entry of new liquidity providers, and increasing overall market transparency.

Section III highlights the importance of a viable client clearing model in enabling the market to successfully transition to central clearing, as experience in other asset classes demonstrates that the vast majority of market participants, including end investors and many principal trading firms ("PTFs"), access central counterparties ("CCPs") through a client clearing model. However, while there has been some use of the Fixed Income Clearing Corporation ("FICC") Sponsored Clearing model for Treasury repos, it has not been utilized to clear cash Treasury transactions. To explain why, key limitations of the Sponsored Clearing model are discussed, and recommended enhancements are provided.

Finally, Section IV discusses relevant considerations in connection with implementing a clearing mandate in the U.S. Treasury market, including the importance of ensuring a viable client clearing model and of applying any mandate to all segments of the market in order to realize the intended benefits.

1 This paper represents the views of FIA PTG and does not necessarily represent the views of FIA as a whole.
2 *See, e.g.*, https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58422&SearchText=ptg.

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II. THE BENEFITS OF CENTRAL CLEARING

More than 75% of secondary cash transactions in U.S. Treasuries are not centrally cleared,[3] and uncleared bilateral repos account for approximately 50% of the U.S. repo market.[4] Transitioning more trading activity in U.S. Treasuries (both cash and repo) to central clearing should be expected to increase market resiliency, liquidity, and transparency, as detailed below.

Increasing Market Resiliency

- **Alleviating Dealer Balance Sheet Constraints.** In the current market structure, primary dealers are largely responsible for intermediating customer transactions. Market volatility and volume can overwhelm this intermediation capacity, as evidenced in March 2020. Central clearing should be expected to increase dealer intermediation capacity by reducing associated capital costs through multilateral netting. For example, research suggests that central clearing of cash U.S. Treasuries would lower daily gross settlement obligations of primary dealers by approximately 60% (and even more so during volatility events).[5]

  Reducing gross settlement obligations means decreasing dealer balance sheet exposures that factor into regulatory capital calculations, such as the leverage ratio. In addition, as detailed immediately below, reducing gross settlement obligations will also significantly decrease the number of settlement fails. Both of these effects of central clearing should result in lower capital costs and greater intermediation capacity.[6]

3 *See* Treasury Markets Practices Group, "White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury Securities," TPMG Consultative Paper, Federal Reserve Bank of New York (July 2018), available at: https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS-DraftPaper-071218.pdf.

4 *See* 83 Fed. Reg. 31896 (July 10, 2018), available at: https://www.govinfo.gov/content/pkg/FR-2018-07-10/pdf/2018-14706.pdf.

5 Michael Fleming and Frank Keane (April 2021) at page 2, available at: https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr964.pdf.

6 *See id.* at page 5, n.5. We note a recent DTCC White Paper suggests that dealer balance sheet savings from multilateral netting may be smaller for cash transactions than for repo transactions, but does not discuss regulatory capital savings from reduced settlement fails. *See* "More Clearing, Less Risk: Increasing Centrally Cleared Activity in the U.S. Treasury Cash Market," DTCC (May 2021) at page 7, available at: https://www.dtcc.com/-/media/Files/PDFs/DTCC-US-Treasury-Whitepaper.pdf.

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- **Reducing Operational Risk.** As a result of multilateral netting, central clearing significantly reduces the number of U.S. Treasuries that must be delivered on a given date. In addition, transparent and standardized workflows simplify the settlement process. Therefore, increased central clearing should be expected to materially reduce settlement fails, which reached nearly $85 billion a week in March 2020.[7] Indeed, research covering on-the-run securities suggests that central clearing could reduce settlement fails by nearly 75%.[8]

- **Reducing Credit Risk.** Central clearing replaces interconnected bilateral counterparty credit exposures with a well-regulated clearinghouse ("CCP"), protecting market participants from the default of their trading counterparties through standardized margin and default management frameworks. As a result, centrally cleared markets should be more resilient during periods of volatility, and are better equipped to manage a large counterparty default.

Increasing Market Liquidity

- **Facilitating New Liquidity Providers.** Central clearing eliminates the interconnected web of bilateral counterparty credit exposures and, in doing so, removes the need for bilateral trading documentation between counterparties. This facilitates the entry of new liquidity providers in the customer segment of the market, as it is extremely difficult to persuade a critical mass of counterparties to dedicate the legal, credit, and operational resources needed to establish a new bilateral trading relationship under the current market structure. Additional liquidity providers lead to more competition and liquidity, and lower transaction costs.

- **Enabling All-to-All Trading.** Eliminating the interconnected web of bilateral counterparty credit exposures and bilateral trading documentation between counterparties also enables true all-to-all trading to develop in the Treasury market, where dealer intermediation is not required. Enabling end investors to participate as price makers (as well as price takers) enhances liquidity and price discovery, particularly since end investors hold

7 *Supra* note 5 at page 24, Figure 11. *See also* Darrell Duffie, "Still the World's Safe Haven? -- Redesigning the U.S. Treasury Market After the COVID-19 Crisis," Hutchins Center Working Paper Number 62, Brookings Institution (June 2020), available at: https://www.brookings.edu/wp-content/uploads/2020/05/WP62_Duffie_v2.pdf.

8 *Supra* note 5 at page 25.

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the majority of outstanding issuance. Even without becoming the dominant method of trading, all-to-all trading can help make markets more resilient during periods of volatility by providing another option in the event dealer intermediation capacity is overwhelmed. Furthermore, all-to-all trading may be particularly helpful in less liquid segments of the market, such as off-the-runs.

Increasing Market Transparency

- **Providing a Robust Data Source.** As more trading activity transitions to central clearing, the CCP becomes an important source of data regarding market dynamics and pricing. This data can be employed to increase transparency for both regulators and market participants.

The benefits above have been observed in other asset classes that have transitioned to central clearing,[9] and support central clearing being considered as a policy response to the disruptions observed in the U.S. Treasury market.[10] The remainder of this paper is focused on the practical steps needed to facilitate such a transition.

9 *See, e.g.*, E. Benos, R. Payne, and M. Vasios, Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act, Bank of England Staff Working Paper (May 2018), available at: https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2018/centralized-trading-transparency-and-interest-rate-swap-market-liquidity-update; and Y.C. Loon and Z.K. Zhong, Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports. Journal of Financial Economics (2016), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443654.

10 *See also* Blackrock, "Lessons from COVID-19: Market Structure Underlies Interconnectedness of the Financial Market Ecosystem," (2020), available at: https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-lessons-from-covid-19-market-structure-november-2020.pdf; Darrell Duffie, "Still the World's Safe Haven? -- Redesigning the U.S. Treasury Market After the COVID- 19 Crisis," Hutchins Center Working Paper Number 62, Brookings Institution (June 2020), available at: https://www.brookings.edu/wp-content/uploads/2020/05/WP62_Duffie_v2.pdf; and Nellie Liang, and Pat Parkinson, "Enhancing Liquidity of the U.S. Treasury Market Under Stress," Hutchins Center Working Paper Number 72, Brookings Institution (Dec. 2020), available at: https://www.brookings.edu/wp-content/uploads/2020/12/WP72_Liang-Parkinson.pdf.

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III. THE IMPORTANCE OF A VIABLE CLIENT CLEARING MODEL

Under a typical central clearing model, market participants can elect whether to become a direct member of the CCP or indirectly access the CCP through a direct clearing member (i.e. as a client of a clearing member). While direct membership may be more cost-effective, it also typically requires a certain scale, given (a) strict CCP eligibility requirements, (b) the operational capabilities required to manage positions, collateral, and settlement at the CCP, and (c) the associated default management responsibilities, including participation in auctions in the event of a member default and potential loss mutualization through contributions to the guaranty fund.

As a result, experience in other asset classes (such as futures, options, and OTC derivatives) demonstrates that the vast majority of market participants, including end investors and many PTFs, access CCPs through an agency client clearing model. The client clearing model developed by FICC for the U.S. Treasury market is referred to as "Sponsored Clearing." While there has been some use of Sponsored Clearing for Treasury repos, Sponsored Clearing has not been utilized to clear cash Treasury transactions.[11] To explain why, key limitations of the FICC Sponsored Clearing model are detailed below:

1. FICC rules permit clearing members to limit a client's executing counterparties

FICC rules contemplate clearing members being notified of the executing counterparty for each transaction a client wishes to clear. Furthermore, FICC rules do not prohibit clearing members from limiting a client's executing counterparties by electing to only clear certain transactions. In particular, many clearing members may only clear transactions that a client executes

11 *See also Supra* note 5 at page 34, n.38 ("all sponsored activity to date has involved repos (and not cash trades).").

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with that same clearing member.[12] FICC rules also do not appear to permit a clearing member to clear a transaction executed between two clients (such as a transaction between two PTFs that are not direct FICC members).

A client clearing model that permits clearing members to limit a client's executing counterparties, including by only clearing transactions executed with that same clearing member, has several negative consequences:

- Requiring the disclosure of, and permitting a limitation on, executing counterparties directly undermines a key benefit of central clearing, which is enabling clients to transact with a broader range of counterparties (and perhaps even directly with each other via an all-to-all model). A clearing member should be agnostic about where (e.g. the execution venue) or with whom (e.g. the executing counterparty) a trade is executed, as the counterparty of a cleared trade is the CCP, not the executing counterparty;
- Clients executing Treasury cash or repo transactions with a number of different executing counterparties may have to establish multiple clearing relationships in order to clear their entire portfolio. This would lead to increased cost (both in terms of clearing fees and margin increases resulting from fragmenting a portfolio across multiple clearing members) and associated operational risk; and
- Transactions in the interdealer cash Treasury market are typically executed with an interdealer broker ("IDB"), and not a clearing member offering Sponsored Clearing,[13] meaning that a lack of clearing members willing to clear client transactions executed with third parties is fatal for this segment of the market.

2. FICC rules do not prohibit trading desks from attempting to influence clearing members

FICC rules do not require clearing members to operate independently from affiliated trading personnel. Trading units affiliated with a clearing member may

12 In order to clear transactions that a client executes with other direct clearing members, a clearing member must establish an "omnibus account" that "could be in addition to or in lieu of a Sponsoring Member Omnibus Account in which *only transactions between a [client] and its Sponsoring Member would be permitted.*" (emphasis added) 83 Fed. Reg. 67801, 67804 (Dec. 31, 2018), available at: https://www.govinfo.gov/content/pkg/FR-2018-12-31/pdf/2018-28376.pdf.

13 We note IDBs are not permitted to clear for clients under FICC rules (Fixed Income Cleared Corporation: Government Securities Division Rulebook (Feb. 1, 2021), available at: https://www.dtcc.com/~/media/Files/Downloads/legal/rules/ficc_gov_rules.pdf ("FICC Rules") at Section 2(a) of Rule 3A).

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have commercial incentives that conflict with those of the clearing business, and may seek to influence decisions of the clearing business regarding whether to offer clearing services to a particular client and the associated commercial terms. These conflicts of interest can impede clients in negotiating clearing arrangements on commercially reasonable terms. For example, many PTFs have reported being unable to locate a willing clearing member under the FICC Sponsored Clearing model for either cash or repo transactions.

3. FICC rules do not permit clients to benefit from cross-margining arrangements

Under FICC rules, only direct clearing members are permitted to participate in cross-margining arrangements, such as between FICC and CME.[14] These arrangements typically lower clearing costs by taking into account offsetting positions, such as futures cleared at CME, when calculating margin requirements. As a result, the inability for clients to leverage cross-margining serves as an economic disincentive to utilize the Sponsored Clearing model. We note that FICC is reportedly engaging with CME to expand the current cross-margining arrangement, and we hope client access is a topic of focus.[15]

It is important to note that the limitations of the Sponsored Clearing model identified above are not a product of unique characteristics of U.S. Treasury market structure. Indeed, similar limitations were proposed when the OTC derivatives market transitioned to central clearing, prompting the Commodity Futures Trading Commission ("CFTC") to act to ensure fair and non-discriminatory access to clearing for clients. In particular, the CFTC prohibited any arrangement that discloses the identity of a client's executing counterparty to its clearing member or otherwise limits the number of counterparties with whom a client may trade, with the CFTC finding that this "could lead to undue influence by [clearing members] on a customer's choice of counterparties."[16] In addition, the CFTC required clearing members to comply with detailed conflicts of interest requirements, including operating independently from affiliated trading businesses.[17]

14 *Id.* at Section 2(a) of Rule 43.

15 "CME, FICC to overhaul Treasury market margining," Risk.net (June 11, 2021), available at: https://www.risk.net/risk-management/7840836/cme-ficc-to-overhaul-treasury-market-margining.

16 77 Fed. Reg. 21278, 21280 (April 9, 2012), available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2012-7477a.pdf.

17 *See* §23.605(d), 77 Fed. Reg. 20128, 20211 (April 3, 2012), available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2012-5317a.pdf.

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In order to address the limitations identified above, and to facilitate a transition of more trading activity in U.S. Treasuries (both cash and repo) to central clearing, we provide the following recommendations to improve the FICC Sponsored Clearing model:[18]

1. Prohibit any arrangement that discloses the identity of a client's executing counterparty to its clearing member or otherwise limits the number of counterparties with whom a client may trade.
2. Require clearing members to operate independently from affiliated trading businesses when deciding whether to offer clearing services to a particular client and the associated commercial terms.
3. Permit both direct clearing members and clients to utilize cross-margining arrangements on fair and non-discriminatory terms.
4. Ensure clients are adequately represented in CCP governance processes (including risk committees) and in working groups involved in determining the rules and design of the client clearing model.

18 We note it is also important to ensure fair and non-discriminatory eligibility criteria for direct CCP membership. Indeed, in the OTC derivatives market, the CFTC took action to eliminate discriminatory eligibility criteria, including by prohibiting CCPs from establishing capital requirements of greater than $50 million or requiring direct members to be registered in a specific capacity (i.e. as a swap dealer). Similar principles may facilitate greater central clearing in the U.S. Treasury market. *See* §39.12, 76 Fed. Reg. 69334, 69436 (Nov. 8, 2011), available at: https://www.govinfo.gov/content/pkg/FR-2011-11-08/pdf/2011-27536.pdf.

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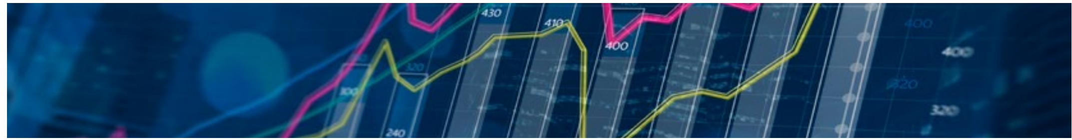

IV. CONSIDERING A CLEARING MANDATE

In light of the expected benefits associated with transitioning more trading activity in U.S. Treasuries to central clearing, we appreciate why regulators may consider a clearing mandate. In this regard, we highlight several points for consideration.

First, it is critical to ensure there is a viable and operational client clearing model prior to implementing a clearing mandate. As noted above, there are several limitations associated with the current FICC Sponsored Clearing model that have prevented market participants from successfully clearing cash Treasury transactions. Imposing a clearing mandate without an operational client clearing model would, in practice, compel market participants to exit the market unless they were able to navigate the direct membership process at FICC. Measures that are likely to reduce participant diversity and liquidity provision in the U.S. Treasury market should be avoided.

Second, many of the benefits detailed above would only materialize if a market-wide clearing mandate was implemented. For example, the netting benefits associated with only transitioning PTF transactions into central clearing are much smaller, given the substantial netting that already occurs directly with IDBs.[19] In addition, a market-wide clearing mandate may provide the regulatory certainty needed for a second CCP to enter the market, providing healthy competition that can reduce clearing costs for market participants. For these reasons, other asset classes have specifically rejected clearing mandates targeted at only certain market segments, such as the interdealer market.

Third, it is important to provide sufficient time for market participants to establish the necessary clearing arrangements and test associated operational workflows. This may also provide an opportunity for CCPs to review and update their cost structure in light of the additional cleared volumes resulting from a clearing mandate.

19 *Supra* note 5 at page 28.

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V. CONCLUSION

FIA PTG appreciates the ongoing discussions regarding market structure modernizations that can increase resiliency, liquidity, and transparency in the U.S. Treasury market. In addition to transitioning more trading activity into central clearing, we recommend that regulators consider:

- **Implementing real-time public reporting.** The current lack of post-trade transparency sharply contrasts with most other asset classes, including those that are less liquid and have a lower percentage of electronic trading than the U.S. Treasury market;[20] and
- **Ensuring appropriate oversight of multilateral trading venues.** We support the recent Securities and Exchange Commission ("SEC") proposal to apply Regulation ATS to multilateral trading venues in the U.S. Treasury market.[21]

We look forward to continuing the dialogue on these important topics. The U.S. Treasury market has undergone significant change in recent years and it is important to modernize the regulatory framework in response. We recommend focusing on measures that support the breadth and diversity of market participation and that are designed to increase market resiliency and transparency. These steps are consistent with reforms in other fixed income asset classes and ultimately will lead to a more resilient, liquid, and competitive U.S. Treasury market.

20 See https://www.fia.org/ptg/resources/fia-ptg-supports-finra-proposed-enhancements-trace-reporting-us-treasury-securities.

21 See https://www.fia.org/ptg/resources/fia-ptg-supports-sec-expansion-regs-ats-and-sci-government-securities-atss.

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