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G30 publishes report on recommendations for Treasury market reform

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The Group of Thirty (G30) has published a report analyzing weaknesses in the U.S. Treasury market and setting out recommendations designed to improve market resilience in periods of stress.

The U.S. Treasury market is currently the most important and liquid securities market in the world. U.S. Treasuries historically have served as a safe asset that companies and investors expect to be able to sell quickly in large volumes for cash, with virtually no impact on the market price of the Treasuries being sold. The U.S. Treasury market has, however, experienced recent periods of turmoil, including the September 2019 Treasury repo market stress and the coronavirus pandemic in March 2020 that created a global "dash for cash." Market participants rapidly sold Treasury securities in an effort to raise cash during a period of uncertainty, straining the capacity or willingness of dealers to intermediate transactions and forcing the Federal Reserve to intervene at an unprecedented level.

This turmoil highlighted the need for reform in the Treasury markets, and a number of prominent figures inside and outside of the government have contributed reform ideas. The Group of Thirty, an independent global body comprised of central bankers, financial leaders, regulators and academics, has now weighed in with its reform ideas in the form of a report produced by the G30 Working Group on Treasury Market Liquidity (G30 Working Group), which is chaired by former Treasury Secretary Timothy F. Geithner.[1]

The G30 Working Group's report is entitled U.S. Treasury Markets: Steps Toward Increased Resilience (G30 Report). It states that the root cause of Treasury market dysfunction during recent stress periods has been that the size of the Treasury market has grown dramatically, without a corresponding increase in "market-making by bank-affiliated dealers … in part because leverage requirements that were introduced as part of the post-global financial crisis bank regulatory regime have discouraged bank-affiliated dealers from allocating capital to relatively low-risk activities like market-making." The G30 Working Group provides ten recommendations, the central goal of which is to "increase, diversify and stabilize market-making capacity in the Treasury markets." Many of these recommendations are generally consistent with reform ideas proposed by other market participants.

Recommendations

The G30 Report includes recommendations to address five sets of key issues: (1) central bank liquidity support for Treasury market functioning; (2) central clearing of trades of Treasury securities and Treasury repos; (3) prudential regulation of dealers; (4) market transparency; and (5) market regulation.

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Standing Repo Facility. The G30 Working Group included as its top recommendation the establishment by the Federal Reserve of a domestic Standing Repo Facility (SRF) to guarantee the availability of repo financing for Treasury securities to a broad range of market participants. Consistent with Bagehot's classic guidelines for central bankers, the G30 Working Group recommended that the interest rate on the SRF be "high enough to discourage extensive use of the facility in normal market conditions but not so high as to stigmatize use of the facility when Treasury repo markets are under stress." Similarly, it recommended that "[h]aircuts on securities financed should be set out in advance and should be sufficiently high that the haircuts alone would provide the Federal Reserve with

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adequate protection against counterparty risk, even in volatile markets." The G30 Working Group also recommended the Federal Reserve make its Foreign and International Monetary Authority (FIMA) repo facility permanent. Finally, it recommended that, over the longer term, the Federal Reserve should "extend access to the SRF as broadly as operationally feasible," which is also consistent with Bagehot's classic guidelines.

- Establishing an SRF and making the FIMA facility permanent were actions under consideration by the Federal Reserve prior to the release of the G30 Report, and indeed hours after the report was released the Federal Reserve announced the establishment of permanent SRF and FIMA facilities. To start, the SRF will be open only to primary dealers, but on October 1, 2021, certain depository institutions will be permitted to express interest in becoming SRF counterparties, with the eligibility criteria continuing to be adjusted over time to include additional depository institutions.[6][5][4]

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Central clearing. The G30 Report makes a number of recommendations pertaining to central clearing of trades and repos of Treasuries, which the G30 Working Group believes reduces counterparty risk, and improves regulatory transparency. The G30 Report notes that central clearing of all such trades through the Fixed Income Clearing Corporation (FICC), the only central clearinghouse for Treasuries, would make risks and associated risk management practices more transparent and subject to enhanced regulation.

- First, all trades of Treasury securities and Treasury repos executed on electronic interdealer trading platforms that offer anonymous trading should be centrally cleared.
- Second, Treasury repos should be centrally cleared. Among other things, this recommendation is intended to "greatly expand[] the capacity of dealers to intermediate under existing accounting and regulatory capital rules by achieving netting of repos and reverse repos that currently bloat dealers' balance sheets."
- Third, market participants and regulators should continue to study how dealer-to-client cash trades of Treasuries might best be centrally cleared, and should assess the private and public policy cases for central clearing. The G30 Working Group recommends a study, rather than moving immediately to require central clearing of such trades, because "[t]he public policy case for central clearing of dealer-to-client cash trades is not as strong as the case for central clearing of IDB trades or Treasury repos."
- Were the above recommendations to be adopted, the G30 Working Group acknowledges that there would be "legitimate concerns" about concentration of risk in FICC. This is particularly true given its affiliation with DTC. Therefore, the G30 Report recommends "robust" government regulation of FICC, starting with a Treasury-led joint review (alongside the Federal Reserve, SEC and CFTC) of FICC's design and operation.[8]

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– **Prudential regulation of bank-affiliated dealers**. The G30 Working Group hopes that its recommendations will increase and diversify the group of dealers willing and able to intermediate Treasury transactions. At the same time, the G30 Report acknowledges that in the near-term the Treasury market is likely to remain reliant upon "a small number of very large broker-dealer affiliates of U.S. global systemically important banks (GSIBs)." Accordingly, the G30 Report includes recommendations intended to eliminate aspects of the post-financial crisis prudential regulatory regime that create "unnecessary disincentives to market intermediation by those dealers" but without "weakening overall resilience of the banking system."

- **Revise SLR so not the binding constraint**. First, banking regulators should consider changes to the supplementary leverage ratio (SLR), which is a risk-insensitive, leverage-based measure of capital adequacy intended to be a backstop to risk-based capital requirements. The G30 Working Group believes that, contrary to intention, the SLR has recently been the binding or nearly binding constraint for many large banking organizations subject to the SLR, thus disincentivizing banking organizations from allocating capital to relatively low-risk U.S. Treasury market making activities. The G30 Report therefore recommends that banking regulators make (unspecified) changes to the SLR to ensure that the SLR continues to function as a backstop, rather than a binding constraint. The G30 Report notes, however, that any reforms in this regard should not reduce the overall capital in the banking system – this may mean that risk-based capital requirements need to increase.
  - During the COVID-19 pandemic, the Federal Reserve modified its capital rules to temporarily exclude U.S. Treasury securities and deposits at Federal Reserve Banks from the denominator of the SLR. This spring, the Federal Reserve allowed this temporary change to expire as scheduled on March 31, 2021, but announced that it would "soon be inviting public comment on several potential SLR modifications." Consistent with the G30 Report, the Federal Reserve has said that its potential SLR modifications, which have not yet been released, will

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not “erode the overall strength of bank capital requirements.”[9]

- **Review GSIB surcharge**. Second, banking regulators should review the GSIB surcharge, which is a risk-based capital surcharge calculated yearly on an individual firm basis based on indicators of global systemic risk. Here, the G30 Report expresses concern that the way indicators are measured based on point-in-time quarterly or year-end data (rather than quarterly or annual averages) could create cliff effects that discourage market-making by bank-affiliated dealers. The G30 Report also observes in passing that the GSIB surcharge “appears” to embrace “punitive” treatment of repos.[10]

– **Prudential regulation of non-bank-affiliated dealers**. Principal trading firms and independent broker-dealers (i.e., those not affiliated with banks) have increased their market-making capacity in recent years, and the G30 Working Group’s recommendations are intended, in part, to further increase market making participation by such firms. According to the G30 Report, this increased participation by non-bank dealers is a “welcome development,” but must necessarily be accompanied by appropriately strong prudential requirements. The G30 Report therefore recommends that the SEC, in consultation with the Federal Reserve and the Treasury, review the robustness of the SEC’s prudential safeguards governing the activities of such firms.

– **Market transparency**. The G30 Report includes a number of recommendations intended to increase market transparency.

- First, FINRA’s TRACE reporting system should be expanded to capture all transactions in U.S. Treasury securities. Current gaps highlighted by the G30 Working Group include a lack of data that captures the dealing activities of commercial banks or principal trading firms.
- Second, TRACE also should be expanded to capture transactions in Treasury repos, about which regulators currently do not collect comprehensive data.
- Third, certain data regarding trades in Treasuries and Treasury repos should be publicly disclosed in near real-time.
- Fourth, the SEC’s Regulations ATS and SCI should be applied to all significant trading platforms for Treasury securities, including both interdealer and multidealer dealer-to-client platforms. Trading platforms for Treasuries are currently exempted from these regulations, and although the SEC in September 2020 issued a proposal to extend Regulations ATS and SCI to certain government and agency securities trading platforms, the G30 Working Group believes the SEC’s proposal does not go far enough, in that it would not cover multidealer platforms that use request for quote or streaming quote protocols.[12][11]

– **Market regulation**. The G30 Report’s final recommendation is a broadly framed recommendation to increase regulatory oversight of the Treasury market. To start, the Treasury, after consultation with the Federal Reserve, should lead an interagency study to re-examine all exemptions of Treasury securities from U.S. securities laws, evaluate the rationales for those exemptions and, where the rationale is not clear or compelling, recommend measures for applying those laws to transactions involving Treasuries. In addition, Treasury should prepare an annual report, including input from the Federal Reserve, SEC and CFTC, on Treasury market functioning.[13]

Law clerk Mary Jane Dumankaya contributed to this update.

See, e.g., Governor Lael Brainard, *Some Preliminary Financial Stability Lessons from the COVID-19 Shock* (Mar. 1, 2021), available here; Darrell Duffie, *Still the world’s safe haven? Redesigning the U.S. Treasury market after the COVID-19 crisis* (June 22, 2020), available here; Chairman Gary Gensler, *Prepared remarks at London City Week* (June 23, 2021), available here.[1]

Walter Bagehot, *Lombard Street: A Description of the Money Market*, pp. 187-189 (John Murray 1919) (1873), available here. *See also* Bill Nelson, *Discount Window Stigma: We Have Met the Enemy, and He is Us* (Aug. 10, 2021), available here.[2]

See Bagehot, *supra* note 2, at p. 51 (during periods of financial stress, central banks should “lend to merchants, to minor bankers, to ‘this man and that man,’ whenever the security is good”).[3]

For example, FOMC meeting minutes from June 2021 state that “a substantial majority” of FOMC participants continued to view the potential benefits of an SRF as outweighing the potential costs. Minutes of the Federal Open Market Committee, June 15-16, 2021, available here.[4]

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Federal Reserve Board, *Statement Regarding Repurchase Agreement Arrangements* (July 28, 2021), available here.[5]

Federal Reserve Bank of New York, *FAQs: Standing Repo Facility* (July 28, 2021), available here. Specifically, depository institutions with holdings of U.S. Treasury, agency debt, and agency mortgage-backed securities greater than $5 billion as of June 30, 2021 or with total assets greater than $30 billion may express interest starting on October 1.[6]

FICC is an affiliate of the The Depository Trust Company (DTC), the principal clearing and settlement system for U.S. corporate debt and equity securities.[7]

See supra note 7.[8]

Federal Reserve Board, *Federal Reserve Board announces that the temporary change to its supplementary leverage ratio (SLR) for bank holding companies will expire as scheduled on March 31* (Mar. 19, 2021), available here.[9]

The G30 Report also suggests that the bucketing of surcharges may also create cliff effects.[10]

Regulation ATS allows alternative trading systems (ATS) to choose whether to register as national securities exchanges or to register as broker-dealers and comply with additional requirements of Regulation ATS depending on their activities and trading volume.[11]

Regulation SCI establishes requirements for the technology systems of certain securities market participants, including certain self-regulatory organizations and ATSs that support trading, clearance and settlement, order routing, market data, market regulation, or market surveillance of securities. [12]

As an example, the G30 Working Group notes the exemption of Treasury securities from the Federal Reserve's authority to set minimum margin requirements for securities purchases.[13]

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