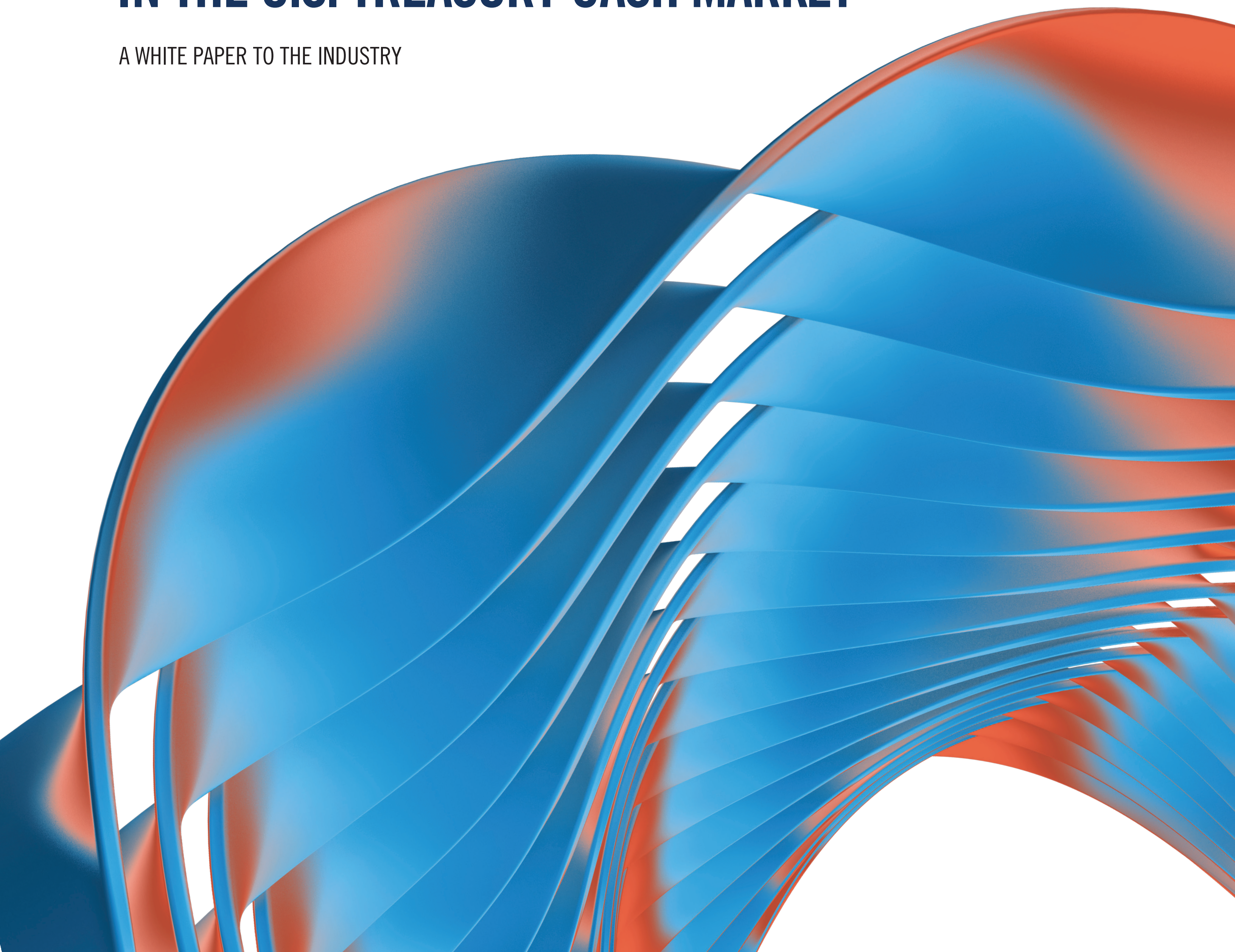
MAY 2021

MORE CLEARING, LESS RISK:

INCREASING CENTRALLY CLEARED ACTIVITY IN THE U.S. TREASURY CASH MARKET

A WHITE PAPER TO THE INDUSTRY



CONTENTS

MORE CLEARING, LESS RISK: INCREASING CENTRALLY CLEARED ACTIVITY IN THE U.S. TREASURY CASH MARKET

One year later, the experiences and the lessons learned from the unprecedented market volatility of the COVID-19 pandemic continue to provide insight into ways to make our financial services operations more efficient, transparent, and resilient.

In the systemically important U.S. Treasury market, the volatility in March 2020 drove record trading volume and volatility spikes. Clearing volumes in U.S. Treasury activity in the Government Securities Division (GSD) of DTCC's subsidiary, Fixed Income Clearing Corporation (FICC), soared to over $6 trillion daily, an almost 43% increase over the usual daily average of $4.2 trillion cleared. FICC effectively maintained orderly processing and settlement throughout the March volatility. FICC's decision to cease to act for a member at the height of the crisis did not result in an adverse market impact nor any loss allocation to members.

Even with that success, DTCC, industry participants and regulators continue to be focused on the fragmentation in the U.S. Treasury market. Recent market activity and attention has rekindled discussion around the evolution of an ideal market structure for these securities. In the face of a fluid and dynamic environment that can potentially expose the market to liquidity and market risk, concerns are growing around bilateral U.S. Treasury clearing.

- The U.S. Treasury market is the deepest, most liquid market, dwarfing in size every other market in the world – and DTCC has long advocated for a greater use of central clearing. **As an industry, we must further explore the causes, the trends, and the risks in the shift to bilateral clearing for cash activity in the U.S. Treasury market.**
- **Greater adoption of central clearing in the U.S. Treasury market would significantly reduce risk and improve resiliency, which is critical to the strength and stability of the U.S. economy.** We must work together to deploy solutions that can broaden participation in central clearing to best manage risk and improve efficiency and transparency in the U.S. Treasury market.

To achieve greater participation in central clearing in the U.S. Treasury market, it is important to briefly review:

- the history of why the U.S. Treasury central counterparty, FICC's GSD was established;
- the benefits that central clearing offers to market participants and the market in general;
- what has changed and the risks that have emerged;
- the improvements that have been made to increase access to central clearing;
- what drives central clearing of U.S. Treasury activity, and;
- where further incentives or regulatory mandates should be explored;

A BRIEF HISTORY OF FICC

The Federal Reserve and several large firms across the industry voiced strong concerns almost 40 years ago about the safety and soundness of the existing processes for clearing and settling U.S. government securities, including the risks associated with the failure of a few major firms, the inefficiencies of manual paper processing of trade confirmations, and bilateral trade-for-trade settlement. In response, the Government Securities Clearing Corporation (GSCC) was established in 1986 by National Securities Clearing Corporation (NSCC) as an industry utility to provide for the clearing and settlement of U.S. government securities.

Like the role NSCC plays in the equities market, GSCC compared transactions and acted as the counterparty for settlement purposes for each net position. This served an important role to maintain the liquidity and integrity of the market for U.S. government securities. From inception through 2002, GSCC cleared about $1.6 trillion a day in trades involving U.S. Government securities.

FICC was created in 2003 to give DTCC customers a consolidated, common approach to fixed income transaction processing by integrating the GSCC and the Mortgage-Backed Securities Clearing Corporation (MBSCC). FICC would continue the same services that GSCC and MBSCC provided, but through separate divisions: GSD and Mortgage-Backed Securities Division.

The U.S. Treasury market is the deepest, most liquid market, dwarfing in size every other market in the world – and DTCC has long advocated for a greater use of central clearing.

After the 2008 financial crisis, FICC was designated as "systemically important," pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). FICC is regulated by the U.S. Securities and Exchange Commission, and, under Dodd-Frank, is overseen by the Board of Governors of the Federal Reserve System.

As the central counterparty (CCP) for U.S. government securities, FICC's GSD provides real-time trade matching, novation, risk management, netting and settlement services for trades in U.S. government debt securities, including repurchase agreements or repos. Securities transactions processed by the GSD include Treasury bills, bonds, notes, zero-coupon securities, fixed rate government agency securities and inflation-indexed Treasury securities as well as agency mortgage-backed securities in its General Collateral Finance Repo (GCF Repo®) service. In 2020, FICC's GSD processed more than $1.5 quadrillion in transactions.

BENEFITS OF CENTRAL CLEARING

DTCC's infrastructure was created to protect market stability and maximize value for the industry. Centrally clearing U.S. Treasury activity through FICC provides the following benefits:

- Central clearing allows trades to be netted across all CCP members, **lowering net settlement exposures**.
- **Bilateral counterparty credit risk is mitigated** through novation to FICC.

- **Market risk is mitigated** through standardized margin processing, collected twice daily. The CCP's mutualized risk program promotes orderly control, wind-down and liquidation in the event of a member default and **reduces the risk of liquidity drain and fire sales** in a stress scenario.
- Central clearing repo transactions **alleviates capital constraints** by enabling members to reduce capital usage and thereby helps **maintain liquid markets**.
- Direct membership in central clearing can **enhance the ability of smaller bank and independent dealers to compete**.
- Central clearing has the potential to improve financial stability by **improving transparency**. FICC currently does not have visibility into its members' Treasury market activity that clears bilaterally, away from FICC. The lack of broad-based participation in central clearing for outright purchases and sales of treasuries obscures market risks (such as concentrated positions, crowded trades, and inadequate margin) and increases exposure to settlement failures.

WHAT HAS CHANGED IN THE U.S. TREASURY MARKET – AND THE RISKS THAT HAVE EMERGED

Prior to 2000, all interdealer broker (IDB) platform users were traditional broker-dealers and FICC members, and all outright purchases and sales of treasuries through IDBs were centrally cleared.[1] However, the Treasury market's evolution over the past 20 years has resulted in an increased share of outright purchases and sales of treasuries through IDBs being bilaterally cleared and settled. Principal trading firms (PTFs) now actively buy and sell large volumes of U.S. Treasuries on an intraday basis using high-speed and other algorithmic trading strategies, but, in general, are not centrally clearing that activity.

> **As an industry, we must further explore the causes, the trends, and the risks in the shift to bilateral clearing for cash activity in the U.S. Treasury market.**

PTFs provide significant liquidity to the U.S. Treasury cash market through market-making. Treasury officials estimate they average about 20% of overall U.S. Treasury cash market volumes and account for around 50-60% of IDB volume in outright purchases and sales of U.S. Treasuries.[2] If an IDB executes a trade with a PTF and another with a FICC member, a mismatch situation arises where one of the resulting trades is bilaterally cleared and the other is centrally cleared, creating market fragmentation. This fragmentation directly reduces the systemic benefits that FICC was created to provide. If a PTF with large open trade exposures defaults, in addition to the loss of liquidity provided by that PTF, there could be much larger systemic impacts, especially if the PTF's default caused its prime broker or IDB to also suffer significant losses or liquidity shortfalls. The contagion risk in this scenario is not insignificant.

1 The Treasury Market Practices Group (TMPG): "White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury Securities," July 2019.

2 Federal Reserve System, FEDS Notes: "Principal Trading Firm Activity in Treasury Cash Markets," August 2020.

Primary Dealers, on the other hand, who transact the other 40-50% of the IDB volume in outright purchases and sales of U.S. Treasuries, are required to centrally clear their U.S. Treasury cash activity, and are subject to strict regulatory standards with regards to leverage, liquidity and capital.

Central clearing of all market making U.S. Treasury cash activity, inclusive of PTF activity, undoubtedly would reduce market, credit, liquidity, and operational risks in the market.

IMPROVEMENTS TO INCREASE AND EXPAND ACCESS TO CENTRAL CLEARING

FICC has made substantial modifications to its fees to make it more economical for market participants who have relatively flat intraday and end of day exposures – like the PTFs – to participate in central clearing. Additionally, significant changes have been made to the Sponsored Service to expand the eligibility of who can participate in clearing.

As a result of its improvement and expansion efforts, FICC now offers multiple means of accessing clearing, all of which are intended to facilitate the participation of a diverse range of market participants.

- **Direct Clearing**: Regulated firms are eligible to become **Direct Members** of FICC's GSD. To become a Direct member of the CCP, a firm needs to satisfy strictly prescribed capital requirements and be responsible to FICC for satisfying margin, liquidity and loss allocation obligations generated by its novated activity. FICC currently has 177 Direct Members.
- **Prime Broker and Correspondent Clearing**. Direct Members are permitted to clear their own activity as well as the activity of their non-member clients by utilizing FICC's Prime Broker and Correspondent Clearing models. In these models, a client's activity is submitted by Prime Broker or Correspondent Clearer with a specific client ticker to be able to distinguish such activity from the Direct member's proprietary trades. In these models, the Prime Broker or Correspondent Clearer is fully responsible for performing to FICC on the trades it submits for its clients.
- **Sponsored Clearing**: The Sponsored Service, initially created in 2005, is now an integral part of the U.S. repo market, offering Direct Members (referred to as **Sponsoring Members**) the ability to sponsor their clients into FICC membership (referred to as **Sponsored Members**) to maximize capital efficiency and thus offer more funding capacity to the market, increasing overall liquidity. There are now 27 live Sponsoring Members and almost 2000 Sponsored Members from 20 approved jurisdictions, with daily volumes ranging from $225-$280 billion (and peaking in March 2020 at $564 billion).
- In order to continue the growth of this Service, FICC is also proposing to create a **Sponsored General Collateral (GC) Service**, which will allow Sponsoring Members and their Sponsored Member clients to settle Sponsored repo in tri-party in the same asset classes as are currently eligible for FICC/GSD Netting Members in FICC/GSD's GCF Repo® Service, including U.S. Treasury securities, agency debentures and agency mortgage-backed securities. The proposed service is subject to regulatory approval.

SHOULD CENTRAL CLEARING BE FURTHER INCENTIVIZED OR MANDATED? MORE CENTRAL CLEARING, LESS RISK

Despite the proven benefits of central clearing and FICC offering improved access for market participants, adoption of central clearing for market participants in the U.S. Treasury market remains uneven, with the PFT community continuing to be markedly absent from FICC.

From FICC's perspective, the issue is clear – where economic incentives strongly favor central clearing, such as with the dealers and buy side firms using the Sponsored Service, we see strong uptake in the CCP; however, where the economic incentives favoring central clearing are weak, we see activity continue to clear bilaterally.

To be more specific, regulatory capital standards that have been put into place in the intervening years since the 2008-2009 financial crisis through Basel II and III, and Dodd-Frank have significantly constrained dealers' balance sheets. However, not all U.S. Treasury market activity constrains a dealer's balance sheet in the same manner, and central clearing alleviates some, but not all, types of balance sheet constraints.

In the case of financing activity in U.S. Treasury market – Treasury repo – the entire notional value of the position has to be recorded on a dealer's balance sheet as soon as the start leg of the repo settles, and unless the dealer faces off against the exact same legal counterparty with respect to an offsetting financing trade of the same tenor, the dealer will not be able to net such balance sheet impact against any other position. The grossing up of the dealer's balance sheet in this manner can have knock on punitive implications with respect to the amount of capital the dealer is required to reserve against such activity, including under the Supplementary Leverage Ratio.[3]

Through the novation to FICC, central clearing offers dealers a unique opportunity to net down – from a balance sheet perspective – their centrally cleared repo positions of the same tenor, and thereby free up their capital to increase funding capacity to the market.[4] According to research that Finadium conducted among repo dealers, netting can compress High Quality Liquid Asset (HQLA) bilateral trading books by 60% to 80%.[5]

Greater adoption of central clearing in the U.S. Treasury market would significantly reduce risk and improve resiliency, which is critical to the strength and stability of the U.S. economy.

In the case of cash activity in the U.S. Treasury market, i.e., outright purchases and sales of U.S. Treasury securities, the trades themselves do not have to be recorded on a dealer's balance sheet in the same manner as repos do, unless the cash trade ultimately fails to settle on its scheduled settlement date, in which case certain modest capital charges come into effect (and having such fails activity in central clearing and subject to FICC's net settlement and risk management processes can help alleviate those related capital charges).

To the extent a dealer is making cash markets and ends up with a relatively flat cash position at the end of the day, its balance sheet would not accumulate in the same manner as it would if that dealer were making markets in repo. However, if the market is imbalanced and there are more sellers than buyers and the dealer ends up buying and holding U.S. Treasury inventory, its balance sheet will ultimately be constrained by the amount of inventory it is holding. This type of inventory-driven balance sheet constraint will occur whether or not the related cash trades are bilaterally or centrally cleared through FICC.

3 Davis Polk & Wardell LLP, Supplementary Leverage Ratio (SLR) Visual Memorandum, September 12, 2014, available at https://www.davispolk.com/sites/default/files/09.12.14.Supplementary_Leverage_Ratio.pdf.

4 Market participants should discuss this matter with their accounting and regulatory capital experts.

5 Finadium LLC, *Netting Rules for Repo, Securities Lending and Prime Brokerage* (September 2014).

To that end, while bringing PTF cash activity in the U.S. Treasury market into central clearing would certainly have important systemic risk benefits for the U.S. Treasury market (as described above), balance sheet and capital relief for dealers will likely not be nearly as strong of a driver for the movement into central clearing as we have seen it be in the U.S. Treasury financing space.

That said, where economic incentives favoring central clearing are weak as is the case with respect to PTFs' cash activity in the U.S. Treasury market (as described above), FICC believes that while industry efforts continue, official sector action will ultimately be required in order to see this activity migrate into the CCP. Such official sector action could potentially take the form of requiring firms that make markets in U.S. Treasury securities, and/or whose U.S. Treasury cash activity satisfies certain liquidity and/or volume thresholds, be required to centrally clear such activity.

CONCLUSION

We hope this paper helps contribute to a better understanding of the importance and risk mitigation benefits of central clearing in the U.S. Treasury cash market. For our part, FICC continues to be an active participant in discussions with the Treasury Market Practices Group and other industry associations on this issue and would welcome a public-private partnership to identify viable options to further increase central clearing in the U.S. Treasury market.

As we have done in the past, we intend to use this paper to engage with clients, regulators, and other stakeholders to discuss these topics which should remain a focus area for the industry.

We actively encourage you to share your thoughts and participate in the ongoing dialogue that we are looking to foster. To become an active part of this industry conversation or to obtain more information on any of the material presented in this paper, input can be provided to:

Murray Pozmanter

Managing Director, DTCC Head of Clearing Agency Services and Global Business Operations

mpozmanter@dtcc.com

James Hraska

Managing Director, DTCC Managing Director and General Manager, FICC Services

jhraska@dtcc.com

For more information on our products and services, visit DTCC.com

For information on careers at DTCC, visit careers.dtcc.com

FOLLOW US ON

DTCC

ADVANCING FINANCIAL MARKETS. TOGETHER.™