Discussion of Bowman, Huh, and Infante's "Balance-Sheet Netting in U.S. Treasury Markets and Central Clearing"

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*The views expressed here do not represent official positions of the Federal Reserve Bank of Chicago or the Federal Reserve System.

Background

- Regulators and observers have suggested that central clearing of Treasury positions might enhance resilience.
  - E.g., could have helped with market dislocations in March 2020.
  - SEC clearing mandate in 2025 for cash transactions; 2026 for repo.

- One key mechanism: multilateral netting.
  - Large dealers are subject to leverage requirements that may bind when Treasury and repo volumes are high.
  - In principle, central clearing can allow assets and liabilities to be netted down.

What is the issue?

- When a dealer buys a security, there is a one-day settlement delay.
- During that time, the dealer is effectively funding a security (asset) with a cash payable (liability) → Leverage increases.
  - Dealers that are subsidiaries of large BHCs are subject to leverage requirements on the total value of assets (SLR).
- In principle, a CCP can reduce the asset side of this computation because payables can be netted against receivables.
- Similar logic for repo positions.
  - Borrowing cash in repo expands assets and matters for SLR; would be nice to net against reverse repo.

Netting

- Cash transactions:
  - Dealers may already net cash receivables against payables for sales and purchases of securities, regardless of counterparty.
  - Consequently – *central clearing makes essentially no difference for capital requirements*.
- Repo:
  - Can only net repo and reverse repo with same counterparties and same maturities.
  - This makes things more complicated…

Repo netting

Why netting effects of cleared repo may be limited…

- GSIBs already try to net as much as possible:
  - Some trades are already centrally cleared.
  - Positions with affiliates and, in some cases, other counterparties are *already* effectively netted.
  - Regressions show dealers actively adjust netted positions.
- Even with clearing, cannot net "open" positions.
- Borrowing and lending maturities may not match.
- GSIBs have net lending positions that have nothing to net against.

Repo data

- Link three data sources for GSIBs:
  - Transactions data from OFR for FICC-cleared trades
  - Transaction data from BONY for tri-party
  - BHC-level data from 5G reports—allows to impute non-cleared bilateral

- Nice data - may be useful for other questions.
- Also rely on OFR 2022 pilot study on NCCB repo transactions.

Authors calculate only 6% of repo trades would benefit from netting under central clearing!

- (Cf. Baklanova et al., 2017?)

Some thoughts…

- What about stress periods?
    - Most of authors’ calculations use data from a fairly quiescent period.
        - 2022Q2 or average since 2020.
    - Clearing benefits may be larger during periods of acute stress—and this is when capital relief may be most systemically beneficial.
    - Fleming et al. (2021) conclude that clearing could have produced significant benefits in March 2020.
        - $800 billion in potentially nettable positions, mostly at eSLR dealers.

Some thoughts…

- These are counterfactual, *ceteris paribus* results.
  - Under a mandatory clearing regime, dealers might expand into activity that could not otherwise have been netted.
  - Authors' regression results show they indeed try to do this!

- Also potential changes in market structure:
  - Smaller dealers could benefit more from central clearing.
    - (Liang and Parkinson, 2020)
  - Expanded clearing might facilitate all-to-all trading.
    - (Duffie, 2020)

Treasury / repo clearing: benefits vs. costs

Benefits

- Reduced counterparty risk
- Multilateral netting
- Margin standardization
- Data/transparency
- Changes in market structure
- Reduced fails and firesales

Costs

- Possible CCP failure
- Procyclical liquidity risk

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(Thanks to Bowman, Huh, and Infante.)

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... Not clear this is a good idea – more work needed!