Jerome H Powell: Treasury markets and the TMPG

Speech by Mr Jerome H Powell, Member of the Board of Governors of the Federal Reserve System, at TMPG Best Practices @ 10: A Look Back and a Look Ahead, Federal Reserve Bank of New York, New York City, 5 October 2017.

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I am honored to join you to celebrate the first 10 years of the Treasury Market Practices Group (TMPG). The TMPG has become an essential forum where industry participants gather under the auspices of the Federal Reserve Bank of New York to address market practice issues as they arise in the fast evolving markets for Treasury securities. Outside this room, you are competitors, and that vigorous competition serves your firms, your customers, and ultimately the U.S. taxpayer. But when members of the TMPG attend meetings, they bring their long experience and deep expertise to bear to safeguard the functioning and overall health of these markets. As I have heard a number of people say, TMPG members check their partisan interests at the door. The TMPG is the place where market participants recognize and address their responsibilities to each other. I know that they take that responsibility seriously, and I encourage all of the market participants here today to take the TMPG's recommendations just as seriously and to adopt them as best practices that will enhance the market's functioning.

I first encountered Treasury markets in a serious way 25 years ago, when I served as Under Secretary of the Treasury for Finance under President George H. W. Bush. These markets made national headlines when we learned that a Salomon Brothers' trader had repeatedly circumvented Treasury auction rules to corner the market for the on-the-run two-year Treasury. As it became clear that Salomon's senior management had known about the issue for several months without alerting regulators, the scandal threatened to bring down one of the largest financial firms of that time. Over one memorable August weekend, we first prohibited the firm from dealing in government securities on behalf of customers, and then reduced that sanction as top Salomon management left the firm and Warren Buffett, then a large Salomon shareholder, agreed to assume the chairmanship of the board of directors. This event takes up a chapter in Buffett's biography, *The Snowball*, and it is a good illustration of why we need the TMPG. I reread that chapter every couple of years, and it still gives me nightmares.[1]

After the dust settled, we had to grapple with the wider implications of the scandal for the market itself and particularly the role of regulatory oversight. We certainly could have used a TMPG to help us with this work, but none existed at that time. Our recommendations were summarized in a joint report to the Congress issued by the Treasury Department, the Securities and Exchange Commission (SEC), and the Federal Reserve Board. Among the issues we considered were how to encourage a level playing field for all market participants, and when and where regulators should respond to the periodic technical difficulties the market sometimes experienced.

As we drew up the report, we were deeply aware of the importance that Treasury markets held for the American economy. The sale of Treasury bonds, notes, and bills finances the U.S. government, and those securities are in turn a primary vehicle for savings for a wide range of U.S. households. Treasury securities are also an important source of collateral within the financial system. This last role has become all the more critical in recent years as regulations have required banks to hold larger amounts of high-quality liquid assets so that they can safely meet their potential liquidity needs.

We also knew that, despite the misconduct by Salomon Brothers, Treasury markets generally worked quite well. These markets are and have long been among the deepest and most liquid markets in the world. It was important to make the auction system more robust to potential manipulation, and we made several recommendations to do so and to open up the process to greater competition. However, in other areas that already worked well, we chose, for example, to open up issuance of securities that were in short supply (or “squeezed”) when needed rather than to risk negatively affecting the functioning of Treasury markets by instituting more invasive regulation.

There is certainly a role for regulation, but regulation should always take into account the impact that it has on markets—a balance that must be constantly weighed. More regulation is not the best answer to every problem. There is also a role for a body such as the TMPG to address market problems.

The TMPG’s approach to “fails” in the Treasury and mortgage-backed securities markets provides a good example. Fails—that is, the failure to deliver collateral in either a cash or repurchase agreement transaction—impose a cost on the party expecting delivery. If the practice were to become too frequent, then it could seriously impair market functioning. But at the same time, it doesn’t make sense to simply outlaw the practice, since that limits flexibility in a way that may not always be called for and would likely reduce market liquidity. The TMPG’s recommendations were carefully calibrated to set financial incentives that would minimize fails and have been a marked success.

The TMPG also plays an important role in helping to “fill in the cracks” between the competing regulations that various Treasury market participants face. Many different institutions and individuals depend on these markets, and the regulatory system reflects that. The Government Securities Act gave the Treasury Department some rulemaking authority over all government securities brokers and dealers. But the act also required these firms to register with the SEC. At the same time, the Federal Reserve regulates many of the banks that are active in these markets, and the Federal Reserve Bank of New York also plays an essential role, both as fiscal agent for the U.S. government and, by nature of its frequent activity in these markets, in conducting monetary policy operations. And of course, the Commodity Futures Trading Commission regulates Treasury futures markets. The agencies work well together, but there is real value in having an industry group help to identify issues that cross regulatory boundaries.

I’ll give two examples. First, in 2016, the TMPG conducted a study of financial benchmarks and uncovered uses of ICAP’s federal funds open rate that had not previously been well understood.[2] As ICAP decided to stop publishing the rate, the TMPG also helped to guide market participants to an alternative that is aligned with the International Organizations of Securities Commissions Principles for Financial Benchmarks while steering the market away from the London Interbank Offered Rate (LIBOR) as a potential alternative—a move that now seems prescient given the subsequent news around the long-run risks to LIBOR. More recently, the TMPG has been busy creating a map of clearing and settlement in Treasury markets, work that I am sure all of the regulatory agencies will find to be of great interest.

All of this is incredibly valuable. In fact, my only regret about the TMPG is that we didn’t think of creating something like it earlier. As regulators, we fully support your work, and will continue to make sure that our own rules support these markets. The Financial Industry Regulatory Authority’s (FINRA’s) new collection of the Treasury transactions of its members through its Trade Reporting and Compliance Engine, or TRACE system, will do much to improve the regulatory agencies’ understanding of the dynamics of this market. But as in the past, we should also be concerned about creating a level playing field. For that reason, the Board of Governors is continuing to negotiate with FINRA for it to act as our agent in collecting similar data from banks. We do not want to create a regulatory arbitrage where the same activity done within a broker-dealer is treated differently than when it is done within a bank.

The TMPG and similar groups around the world play an important role by helping both regulators and industry leaders address market concerns before they threaten market function. I thank the members for their service and look forward to today's discussions.

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[1] Alice Schroeder, *The Snowball: Warren Buffett and the Business of Life* (New York: Bantam, 2009).

[2] The ICAP Fed Funds Open rate was a daily indicator published by ICAP, a broker in the federal funds market, as to where a representative federal fund transaction would be priced at the start of the U.S. trading day. ICAP did not consider the rate to be International Organizations of Securities Commissions compliant, although it was nonetheless used as a financial benchmark by some market participants. ICAP ceased publication of the index in September 2016.