Transparency In Treasuries

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Market structure principles, not prescriptions, are needed for the U.S. Treasury market

The U.S. Treasury market needs more oversight. Our research and my personal observations over the past several years have made that clear. Oversight, however, does not mean highly prescriptive rules that dictate everything from when you're allowed to pick up the phone to acceptable electronic trading protocols. Oversight in this case should consist of guiding principles, albeit enforceable ones that ensure regulators have a clear view into market activity and that limit the likelihood of systemic shock whether due to economic events or software bugs.

One of the biggest "principles" being debated now is the need for real-time trade reporting. It is generally seen to be a good thing - but only if implemented properly. And the definition of properly, unsurprisingly, is different depending on who you ask.

Let the Regulators See

We made our view pretty clear in the research we published examining the UST market last fall:

"The level of opacity that still exists in the market for the debt issued by the largest economy in the world is stunning"

So yes, the UST market needs reporting. The questions then are exactly of what and to whom?

First, the indisputable: U.S. regulators should be given access to as much real-time trading data as possible. They do not have access to technology and people to truly monitor that data in real-time, with a goal towards taking action if something goes awry. That said, simply having that data available at a moment’s notice to figure out what is or did go on is a step forward. Even if certain market participants would rather not be so transparent to Washington, they could never say that publically and survive. As such, they are all on the bandwagon.

Unfortunately, creating and enforcing rules requiring reporting to regulators still leaves much of the market opaque. Remember that this is an OTC market, so trading does not need to include anyone other than the two counterparties. This means that every market participant would have to find a way to self-report without an exchange to do it for them. Furthermore, roughly 60 percent of U.S. government debt is held by foreign governments and sovereign wealth funds. Trading from these entities with other non-U.S. entities will be hard if not impossible to track.

Things would also get sticky if bank-internalized trades had to be reported. It is nearly impossible to estimate how much volume this constitutes, but suffice to say the volume executed within the biggest primary dealers is material. And determining which types of internalized trades needed to be reported, such as those between affiliates of that bank, is non-trivial. This issue led to years of debate after The Dodd-Frank Act was passed, and I suspect the complexities (and pushback) here would be even greater given near ubiquitous use of U.S. Treasuries across business lines.

How public is public?

Then there is public reporting, similar to what the U.S. corporate bond market has via TRACE. The issues outlined above all still apply here, but the cost/benefit analysis for public reporting is less clear. As a market structure analyst, I love the idea of more available data. Smaller, less active market participants might also find more trade data useful as they work to ensure the price they are giving or receiving is within line with the rest of the market.

But even for smaller market participants, does the U.S. Treasury market really have a transparency problem?

We've had many conversations with market participants that feel price transparency in the U.S. Treasury market is actually quite good. If you are trading or investing in U.S. Treasuries for a living, the data available via trading venues and market data providers is quite robust, especially considering the lack of required reporting and/or a central "tape."

This all leaves me conflicted as to the public good that will be had by requiring all U.S. Treasury trades to be openly reported. On one hand, given the importance of the market, it would benefit not just investors but would help set mortgage rates and funding the government of the largest economy in the world. Of course, the taxpayers should have a clear view into its functioning.

But on the other hand, does the transparency found in public reporting outweigh the costs? Not just the hard dollar costs of setting up and maintaining the reporting infrastructure, but also the harder to measure costs of making all trades visible to competitors and predators alike. If spreads widen and liquidity dries up even slightly, it is the taxpayers who will pay via their retirement accounts.

The reality though, regardless of which side you sit, is that public reporting is coming. The market is too big and too important and receives too much political attention to remain even slightly opaque. Furthermore, it is increasingly hard to argue (despite my arguments above) that the U.S. Treasury market should continue on without reporting requirements when the equity market, futures market, swaps market and corporate bond markets all require trades to be reported. As such, it is now more prudent to begin discussing the way forward that provides the greatest ROI to the market as opposed to arguing against it happening at all.

That however, is equally unrealistic.

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