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2023 Financial Markets Group Fall Conference Recap

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On October 4, 2023, the Financial Markets Group (FMG) of the Federal Reserve Bank of Chicago hosted its tenth annual Fall Conference. The theme of this year's conference, Building Resilience: Potential Improvements to Financial Market Structure and Stability, featured participants in academia, financial markets, and regulatory policy. The conference featured two fireside chats with keynote guests. Senior policy advisor Robert Steigerwald hosted the first discussion with Rostin Behnam, chair of the U.S. Commodity Futures Trading Commission (CFTC). Federal Reserve Bank of Chicago President Austan Goolsbee then hosted the second fireside chat with Raghuram Rajan, professor of finance at the University of Chicago's Booth School of Business; this [discussion](#) was made available to the public. A U.S. Treasury official also discussed updates to the Financial Stability Oversight Committee's (FSOC) Risk Assessment Framework.

The conference featured two panel discussions. Ketan Patel, policy advisor and head of financial markets risk analysis led the first panel discussion, titled "Dynamics of Treasury Market Liquidity and Market Structural Reform Considerations." Cindy Hull, assistant vice president and head of FMG, led the second panel, titled "Financial Stability: Lessons for Improving Management of Systemic Risk from Recent Events."

The conference was held under the Chatham House Rule, with no press in attendance. Below, we highlight some key takeaways and themes from the conference.

Key takeaways:

- The banking stresses of 2023 and other stresses impacting financial markets since the start of the Covid-19 pandemic highlighted that liquidity could disappear quickly for individual firms and lead to contagion in a highly interconnected financial system without robust backstops.
- Central clearing has become much more concentrated in recent decades, as the number of intermediaries has declined amid a marked increase in cleared trading activity. If the industry continues to consolidate, this could further concentrate risk and potentially hamper clearing capacity.
- While the U.S. Treasury market remains the most liquid market in the world, expanded issuance, as well as geopolitical and other risks, could cause some pricing disruptions in the years ahead. Greater transparency, expanded central clearing, and new trading venues may ease some of these risks, particularly for securities that tend to have lower daily trading volumes.

Systemic risk

Systemic risk was in focus throughout the conference, given the banking stress event earlier in 2023 that had led to the closures of several banks. Participants agreed that there were clear signs of poor risk management and asset/liability mismatches at some of the most impacted institutions. In addition, the rapid speed at which deposits can now leave banks makes the financial system more vulnerable to shocks at smaller institutions. However, participants also highlighted that this was the latest in a string of shocks to the financial system over the past several years, including the start of the global Covid-19 pandemic, unprecedented volatility in commodities markets due to the Russian invasion of Ukraine, and a crash in crypto currency prices and the fall of FTX.

Throughout the conference, participants discussed the interconnectedness of the financial system and its associated risks and benefits. In his discussion with Rajan, Goolsbee highlighted that, despite interconnectedness in financial markets being the culprit of financial crises for several decades, the financial system continues to grow even more interconnected. Rajan

described this tendency as a two-sided coin. Greater interconnectedness among firms allows liquidity to more easily flow to where it is needed within the system. However, it also allows the potential for individual firm insolvency to flow throughout the system.

Some participants representing central counterparties (CCPs) also commented that interconnectedness is a prominent concern for their firms, and that CCPs continue to invest in efforts to identify indirect exposures of clearing members and their clients. They noted that there is limited public information on firm-level exposures and that greater transparency in this area would ease concerns.

Some participants noted the potential role for a central bank liquidity backstop for non-banks to mitigate systemic risk. In his talk, Rajan questioned whether non-banks should have access to central bank liquidity support if they can pledge eligible collateral. He also highlighted that the Bank of England was reportedly considering expanding the types of counterparties eligible for their existing liquidity intervention programs. Relatedly, participants remarked that, if non-banks received access to central bank liquidity tools, they should also be subject to many of the same requirements as banks, such as expanded supervision.

Given the focus on systemic risk, a U.S. Treasury official presented proposed updates to the FSOC's Risk Assessment Framework, which were subsequently finalized on November 3, 2023. These efforts were focused on four key FSOC priority areas: non-bank financial intermediation, Treasury market resilience, climate-related financial risk, and digital assets. The purpose of the updates was to detail the approach FSOC would take in assessing and responding to financial stability risks in these four areas. The updates described FSOC's monitoring functions, as well as how FSOC will consider which tools to use in identifying specific risks.

Central counterparties

Concentration of the CCP ecosystem was a consistent theme throughout the day. Several participants highlighted that the number of futures commission merchants (FCMs) at U.S. derivatives CCPs has declined significantly in recent decades. As a result, clearing activity for customers was becoming more concentrated among the remaining intermediaries. One participant noted that the reason the number of FCMs has declined so markedly is that this business is not profitable for most firms, and barriers to entry are high due to costs associated with the necessary technology investments and risk management expertise. A few participants also noted that the then-proposed (and subsequently finalized) capital rule from the Federal Reserve would increase the global systemically important bank (GSIB) surcharge and further increase the cost of providing clearing services. If implemented, this could create new risks to clearing capacity at a time when more may be needed if the proposed mandate by the Securities and Exchange Commission to clear Treasury securities and repo transactions was also implemented.

The reduction in the number of FCMs has occurred as margin held at CCPs has increased sixfold, largely due to the increase in the open interest from trading activity that is centrally cleared. One participant argued that, if additional large FCMs were to exit the clearing business in certain types of derivatives, there were risks that the remaining intermediaries would not be able to absorb their clearing activity volume, given the size and the resulting capital considerations. One participant questioned whether the remaining intermediaries have the aggregate capacity to properly manage this increasingly concentrated risk. One participant noted that the FCM decline has caused some market participants to seek direct clearing memberships with CCPs. This brings new risks to the CCP ecosystem and raises concerns among traditional FCMs about risk mutualization in the event of default.

In addition to CCP concentration-related issues, participants discussed several other ongoing themes in centrally cleared markets:

- *Systemic Risk Mitigation:* Participants from CCPs and FCMs noted that they had been taking new steps to mitigate exposure to systemic risks, including enhancing monitoring of, and outreach to, large clients to understand their concentration risk, elevating the roles of internal risk experts when taking on new clients, and raising individual margin requirements on some clients. Conference attendees also expressed support for more stress testing, increasing margin and collateral requirements, and requiring more information from counterparties as ways to protect derivatives market participants from shocks.
- *Expanded Cross-Margining:* A participant argued for expanded cross-margining between CCPs to improve netting benefits of clearing, particularly in the context of additional regulatory pushes toward more clearing in more markets, arguing that netting benefits need to be expanded to end clients.
- *Improved CCP Initial Margin Models:* Participants emphasized the importance of robust and transparent CCP initial margin models, particularly given the backdrop of risks impacting financial markets in recent years. Relatedly, a participant argued that margin held at CCPs could decline notably in the case of an extended period of low market volatility, creating a situation in which a stress event could be very disruptive as required margin levels rise suddenly.

- *Recovery and Resolution Planning*: Some participants touched on CCP resolution planning, given recent work by the Financial Stability Board (FSB). Some participants argued that, in the case of a large default with a CCP, resources should be focused on *recovery* of a CCP and should not be siloed for a potential resolution process. One participant urged against imposing the ideas prominent in bank resolution planning onto CCPs, as CCPs are distinctly different types of entities.

Treasury market resilience

Despite 2023's market volatility caused by an array of global events, conference participants largely agreed that conditions across the Treasury markets remained orderly. However, they also highlighted several risks on the horizon, including steep increases in expected Treasury supply amid an expected decline in the Federal Reserve's holdings, observed declines in foreign demand for Treasury securities and risks that recent U.S. sanctions policies could lead to further declines and potential constraints in dealer capacity to provide liquidity.

Participants expressed support for the Treasury Department's efforts in standing up a Treasury security buyback program but pointed out two potential implementation challenges. There may be instances in which market pricing at the time of the operation could cause the Treasury not to purchase any securities. This contrasts with market participants' experiences with the Federal Reserve, in which all announced purchase operations are fully executed. Another participant noted that there could be a negative feedback loop created by replacing current off-the-run securities at specific maturities with on-the-runs at similar maturities, as these would eventually become illiquid off-the-run securities once they became more seasoned.

The participants shared many ideas regarding the role of capital requirements and other regulations on conditions in the Treasury market. One participant noted that bank capital rules created challenges in allocating capital to intermediation activities in the Treasury securities and repo markets. Another participant specifically pointed to the supplementary leverage ratio (SLR), which requires banks to hold a minimum level of capital against assets, including Treasury securities, as hampering traditional dealer activity in the Treasury markets. In contrast, another participant argued that the SLR was not a predominant driver of dealer balance sheet scarcity among the array of other concerns in dealer decision-making, and instead argued that expanded central clearing would have alleviated the pressures seen in some recent stress episodes, particularly the Treasury repo market stress of 2019.

Participants also discussed the Treasury cash-futures basis trade, which grew in size during 2023, alongside large increases in Treasury issuance. A basis trade aims to exploit a difference in price between a derivatives contract and its underlying cash instrument. In the Treasury context, market participants purchase cash Treasury securities while selling Treasury futures contracts, financing the positions by borrowing Treasury securities in the repo market. Most participants agreed that the market risk associated with the basis trade is low. However, participants agreed that a deeper investigation into the long positions in Treasury futures would be beneficial to better understand the financial stability risks associated with a sudden unwind of this trade. Relatedly, participants also discussed the limited data transparency in the uncleared bilateral repo market, with a few noting that this raises questions about hidden risks from excessive leverage, counterparty risk, and repo rate volatility. Some participants suggested that increasing transparency in the Treasury market could potentially help address the questions around the financial stability implications of the basis trade.

Participants also discussed the SEC Treasury clearing mandate and the role that expanded central clearing should play in fostering new venues for trading Treasuries, such as all-to-all trading. One participant argued that all-to-all trading should not be explicitly coupled with expanded central clearing. The participant elaborated that the motivation for centrally clearing transactions is to mitigate counterparty risk and ensure that there is adequate collateral behind a trade in otherwise opaque markets, and that this should be separated from *how* markets transact. Another participant countered that trading venues were relevant to these developments, noting that there are robust central limit order books for trading the most recently issued Treasury securities, but that there was room for new venues for securities that are less actively traded.

Market liquidity

Another prevalent theme throughout the conference was market liquidity. Participants highlighted that dealers faced shrinking capacity to provide liquidity across markets, driven by a range of factors, and that this has led to a rise in liquidity provision from non-bank financial institutions. From a regulatory perspective, several participants argued that when policymakers seek to eliminate dislocations in liquidity access, there should be a focus on retaining as many liquidity providers as possible.

In his discussion with Goolsbee, Rajan described liquidity as a "nebulous concept," noting that the availability of liquidity can abruptly disappear for some market participants due to a range of factors. He further argued that liquidity depends on how easily assets can be turned into reserves, but that when there is a spike in demand for reserves, many normally liquid assets lose that quality.

In all, the conference produced a series of productive conversations around financial market resilience, and we look forward to continuing these conversations in the future.

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