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By Electronic Mail (rule-comments@sec.gov)

Secretary
Securities and Exchange Commission
100 F Street NE

Washington, DC 20549-1090
USA

Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities (File No. S7-23-22)

Voluntary regulated innovation – a comprehensive solution for all market participants, direct and indirect

Ladies and Gentlemen,

M|E|W Consul ("MEW") appreciates the opportunity to respond to U.S. Securities and Exchange Commissions request to comment regarding "Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities" (File No. S7-23-22).

MEW is Konstanz/Germany based. Area of expertise is risk management, from strategic and structural point of view. The focus is mostly on aggregated and systemic risk, less on individual market participants or transactions.

In your report it says on page 76: "… Finally, increased central clearing should enhance regulatory visibility in the critically important U.S. Treasury market. Specifically, central clearing increases the transparency of settlement risk to regulators and market participants, and in particular allows a CCP to identify concentrated positions and crowded trades, adjusting margin requirements accordingly, which should help reduce significant risk to the CCP and to the system as a whole. …"

For MEW, this is the most important statement, since it highlights the double edged sword of central clearing and correspondent collateralisation, and will be evaluated on basis of recent upheaval in the British government bond (gilt) market.

Successfully improving the stability of the U.S. Treasury market via central clearing depends on two conditions:

1. Necessary = improving risk visibility as mentioned already

2. Sufficient = reliable collateral management/margin calls

As mentioned in your report, better transparency due to central clearing is improving risk visibility, since risk can be evaluated on individual transaction as well as aggregated basis. The result is improving appropriate level of initial margin. But we have to keep in mind the more challenging variation margin in general is reactive, not proactive. Meaning, collateral level overall most of the time is lagging risk/volatility event.

Assuming CCP collateral regime works well, CCP and thus centrally cleared U.S. Treasury market stability is greatly dependent on liquidity and collateral management of customers in general – direct and indirect.

For a current analysis and stress test of central clearing of government bonds following volatility events one can look at recent developments in the British gilt market.

The rout in long-dated gilt market is a warning example. Well regulated and conservative run UK pension funds are using derivatives to manage their long-term liability-driven investments (LDI) under defined pension plans. LDI is one of the concentrated risks as mentioned in your report - fully transparent and well known. Only a small portion is centrally cleared currently.

When interest rates soared it triggered massive selling of long-dated gilts in anticipation of variation margin calls. Private liquidity providers vanished and Bank of England was forced to intervene. The central bank feared there would have been a self-reinforcing downward spiral that would threaten severe disruption of core funding markets and consequently widespread financial instability, according to deputy governor Sir Jon Cunliffe. The ripple effect is nonetheless considerable across European bond markets as a whole – government and corporate.

As a response, pension funds have started liquidating other illiquid investments. In a forced seller environment that often requires deep discounts, which negatively impacts the funding level, and hence potentially triggers the need for additional contributions from sponsor corporations.

Based on publicly available fund flow statistics, UK pension funds seem to reinvest freed up capital in money market funds (MMF), in preparation for future volatility events and additional variation margin calls, which should concern authorities. Front running liquidations, already known from routs in open-ended investment fund sector including MMF, will likely become a more regular occurrence.

Finally, pension funds have started renegotiating the credit support annex (CSA), which determines bilateral collateral and margin policy. A switch to so-called “dirty” CSA will widen the range of acceptable collateral, f.i. corporate financings and structured products. As a result, the markets are becoming even more intransparent, and in case of future dislocation could very fast destabilise wider parts of the financial system.

Combined adjustments confirm that risk is not really reduced, but is getting spread across financial system and real economy. In case of future volatility event, authorities will possibly not be able to stabilise as fast as needed.

No we can analyse the difference centrally clearing of gilt market would expectably have made, from a systemic point of view.

CCP would have been aware of concentrated LDI risk, hence adjust the level of initial margin accordingly. Once external event triggers soaring yields and volatility, additional variation margin call is sent. Combined collateral level is not necessary different to current level under decentralised clearing.

Since CCP collateral policy is consistent and transparent, and pension funds decision is unaltered based on same historic data and competition pressure, they would hold even less liquidity buffers. Hence, we would still expect emergency liquidations in the market.

Because other market participants also know CCP collateral policy, one should expect additional front running liquidations to benefit from forced liquidations by pension funds. Overall selling pressure in gilt market would potentially be even more severe.

As a result, pension funds will shift even more capital from illiquid assets to MMF. That leads to further pressure on funding level and need for additional contributions from sponsoring corporations.

Only renegotiations of CSA will become obsolete, since CCP collateral policy is not negotiable.

The pro-cyclicality risk of central clearing and correspondent collateralisation of derivative transactions in general has been thoroughly analysed by regulatory authorities and central and private banks globally, among others. Above LDI example leaves MEW to expect the same will be true with regard to central clearing of U.S. Treasury securities.

Regarding U.S. treasury securities we can therefore expect that boosting central clearing including consistent and transparent collateral management policy, authorities will be much better prepared to handle similar situations. But the price to be paid for better transparency is higher concentration. Authorities know margin calls in advance, but it will hit all counterparties at the same time and in the same way. Other market participants know as well, probably front running short selling the market in anticipation of forced liquidations. Unless additional "balancing valve" is introduced, the selling pressure could be even more severe. Loosening collateral standard obviously not the solution, otherwise CCP itself are at risk.

Interim conclusion, without accompanying measures central clearing is moving U.S. Treasury market from intransparent and uncoordinated to transparent and coordinated, but potentially even more instable due to increased cyclicality.

Nonetheless, MEW believes moving U.S. Treasury securities to central clearing is the advisable next step. What is missing is a complementary initiative to address cyclicality - liquidity and collateral driven.

Counter-cyclical solutions as "balancing valve" sometimes are called anti-procyclical tools, automatic stabilisers, or shock absorbers; MEW solution is called KLF. Technically, all publicly known private solutions are a kind of liquidity and collateral back-up insurance.

Main objective is expanding the time window for market participants to adjust to sudden and unexpected change in market environment. Once more we can reference it to recent gilt market upheaval. With collateral back-up insurance cover pension funds can stretch repositioning their LDI over an extended period of time. Hence, no emergency liquidations and no Bank of England intervention are necessary.

With insurance premiums significant lower than cost of holding collateral direct, insured market participants (direct and indirect, financial and non-financial) can withstand market and competition pressure.

Key hurdles are guaranteeing that solution doesn't get misappropriated for speculative purposes, as happened to previous insurance structures, and is reliable even during periods of severe market stress. Less sophisticated market participants are not capable of doing their own due diligence, that's why pre-launch product regulation is essential. For cost efficiency reason (commoditisation) and wide application including, not only structure itself should be regulated, but also economics, documentation, distribution, supporting assets, settlement, etc. That's why we prefer to call it certification, in reference to earlier FDIC consultations.

Thus, MEW believes a comprehensive solution consists of two legs:

1. Central clearing of U.S. Treasury securities and repos as outlined in your proposal

2. Pre-launch product certification of liquidity and collateral back-up insurance solutions

Implementation of solution requires collaboration: (1) among regulatory authorities, and (2) public with private sector. Process to implement a reliable, fully transparent and regulated solution could be as follows:

1. Private sector risk managers such as MEW develop liquidity and collateral back-up insurance structures

2. Reference transactions executed in closed environment, f.i. at the New York Innovation Center (NYIC), a strategic partnership of the New York Fed and BIS Innovation Hub, as part of FedNow initiative

3. Pre-launch product regulation, for example FDIC certification (structure, economics, documentation, distribution, settlement, etc.), with ongoing adjustments thereafter according to changes in regulatory or technical environment

4. Application by regulatory authorities: nationally, such as U.S. Security and Exchange Commission, and internationally

5. Distribution and day-to-day management by U.S. regulated financial institutions exclusively (banks and non-bank financial institutions; risk managers explicitly excluded from operations)

The non-operational position of risk managers is of central importance for several reasons:

1. Pure staff function to guarantee strict neutrality, similar to regulatory authorities

2. Every insurance structure has to balance standard of cover and profitability; although pre-launch product certification will secure standard of cover, with risk manager not being part of operations additional firewall is implemented

3. Outsourcing day-to-day operation to regulated financial institutions prevents unnecessary and expensive duplication of infrastructure, forces higher standardisation; together it simplifies regulation, promotes commoditisation, lowers break-even cost and widens distribution even to smaller and less sophisticated financial institutions and non-financial corporations

4. Separation of duties enables decentralisation, which guarantees that insurance solution itself will never pose a systemic risk

5. Since both, insurance structure and day-to-day management are fully regulated, although a decentralised structure, the solution as a whole is fully regulated from inception

Although non-financial corporations and central clearing other than U.S. Treasury securities and repos is beyond the scope of this consultation, if more problems can be addressed with the identical solution than why not aim higher, f.i. why no take steps in preparation for digital financial system next.

Final conclusion, MEW is convinced that strong regulation is central to achieving stable centrally cleared U.S. Treasury securities market, including voluntarily of private sector solutions:

1. innovation

2. product level

3. pre-launch

Due to combination of central clearing of U.S. Treasury securities and repos with private counter-cyclical liquidity and collateral back-up insurances the core of the financial system will be stable again.

Independent of trigger, following volatility event financial system will automatically return to stable equilibrium, even without central banks interfering. Regular interventions as described on page 164 et seqq. of your report or in the gilt market recently no longer necessary. Potential frictions between stabilisation measures and monetary policy mostly avoided.

Since properly structured insurance solutions are not limited to financial sector only, it also functions as reliable real-time risk radar of the financial system as a whole.

Best regards,

Manfred E. Will
Founder & CEO