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Wave of New Regulations Stokes Fears of Treasuries Shortage

By Joe Adler – August 9th, 2013

The next crisis may arise not from a rash of sick banks but rather a shortage of medicine.

The onslaught of new federal regulations, including everything from Basel capital and liquidity rules to Dodd-Frank Act margin requirements for swaps trader, is helping drive banks' demand for Treasury bonds and other safe collateral. While government debt is now plentiful, some worry demand could someday exceed supply, making such assets costlier and leading to private-sector alternatives reminiscent of the securitization boom.

"Historically, when there are not enough government bonds as collateral, the private sector creates 'safe debt.' In the last 30 years this has taken the form of AAA"-rated asset-backed securities, said Gary Gorton, a professor at the Yale School of Management. "Bank regulators ought to focus on overseeing the production of private collateral "\xA6 [to] try to ensure that it is safe."

To comply with higher capital requirements, banks can opt to reduce risk on the asset side of their balance sheet instead of just raising equity. That makes government securities appealing, and having less-risky assets is also essential for implementing liquidity rules.

Treasuries are also likely to be an instrument for obeying a Dodd-Frank derivatives rule affecting banks. Under a pending proposal, the collateral that swaps-dealing banks can use to raise their margin levels is limited to cash, government bonds and debt from government-sponsored enterprises.

To raise capital ratios, "you can obviously raise more capital "\xA6 but that's very unattractive for existing shareholders because they get diluted," said Steve Hanke, a professor of applied economics at Johns Hopkins University and senior fellow at the Cato Institute. "But you can also reduce the risk assets that you have on your balance sheet. How do you reduce risk assets? You buy risk-free assets; you go into cash and Treasuries."

But other moves by regulators could also have implications for the Treasuries supply, observers said, including the final form of Securities and Exchange Commission rules for money market mutual funds and even efforts to reform the housing GSEs. Some say the huge demand for Treasuries could not only squeeze banks' returns but also restrict access to government securities for other types of investors.

"As the SEC considers their money market rules, they should think about to what extent will their rules increase the demand for Treasuries at a time when there are various other regulatory demands being placed on Treasuries, and will there be enough to meet the needs of money market investors," said Wayne Abernathy, executive director of financial institutions policy and regulatory affairs for the American Bankers Association. "It should also be a concern for regulators when they think about implementing the Basel liquidity rules.

"Folks at the Fed are beginning to realize that this is a growing problem."

But the bigger issue for regulators may be what types of safe assets are developed in the private market to help soften the demand for government securities.

Some analysts point to the much lower levels of government debt in the years leading up to the housing boom as one of the contributing factors behind the growth of asset-backed securities, including those backed by residential subprime mortgages that ultimately blew up.

"Historically, this was a very big reason that we ended up in the crisis that we ended up in," said Andrew Metrick, a finance and management professor at Yale.

At the moment, there isn't a problem because government debt is in abundance. But many, including Metrick, say a framework is still needed to ensure a safer private system can pick up the slack if the situation changes.

"The two pieces of good news are, No. 1, in the short run we have a lot of high-quality assets because "\xA6 the U.S. government still isn't going bankrupt," he said. "No. 2, the top people at central banks around the world completely understand this now in a way that none of us did 10 years ago."

But he added that there is no "actual solution of what we do when we notice that there's a problem - when one day at some point the demand for these assets will outstrip the supply."

A paper released in May by the Bank for International Settlements suggested the risk of demand exceeding supply was low. The paper estimated about $4 trillion in additional demand for high-quality assets resulting from new liquidity rules and derivatives reforms, but added that "outstanding amounts of AAA- and AA-rated government securities alone "\xA6 increased by $10.8 trillion between 2007 and 2008."

And some economists believe an "overcollateralized" system should breed confidence, not fear.

"This is probably a very high-class problem to have. It's a much better problem than the opposite, where institutions are more levered, aren't as liquid and have more funding that is not collateralized," said Mark Zandi, chief economist of Moody's Analytics.

Others are not so optimistic. After the release of the BIS paper, Karen Shaw Petrou, managing partner of Federal Financial Analytics, said in a memo to clients that "a locomotive is barreling down the tracks pulling freight cars loaded with rule after rule requiring banks to hold lots more sovereign debt and similarly 'safe' collateral."

She noted that the availability of high-quality assets could take a hit, for example, from the anticipated wind-down of Fannie Mae and Freddie Mac in a housing finance reform plan. The two GSEs, along with the Federal Home Loan banks, issue about $7 trillion in debt now deemed to be safe assets. Without Fannie and Freddie, she said, "about $5 trillion of HQAs go bye-bye."

"It's a classic example of unintended consequences resulting from a lot of well-intentioned rules hitting at the same time, each one of which demands that the biggest banks hold far higher amounts of high-quality assets," Petrou said in an interview.