Testimony for the House Committee on Financial Service's Task Force on Monetary Policy, Treasury Market Resilience, and Economic Prosperity

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I appreciate this opportunity to appear today before this Task Force. The U.S. Treasury market has been a focus of mine while I was Treasury Undersecretary for Domestic Finance from 2021 to 2025, and before that, while I was Director of the Division of Financial Stability at the Federal Reserve Board. Today I will focus on the Treasury market and its importance for monetary policy and financial stability, and highlight areas where additional reforms are needed to strengthen its resilience.

U.S. Treasury market

There is no larger thoroughfare for global capital than the U.S. Treasury market. It averages around $900 billion in transactions per day, with high volume days in recent years around $1.5 trillion.[1] In addition, there is roughly $4 trillion in Treasury repurchase agreement—or repo—financing each day.[2] And average daily trading volume in U.S. Treasury futures was $645 billion in notional in 2023 and higher in 2024.[3]

The Treasury market, the largest and most liquid financial market in the world, serves several critical functions. It is key for financing our government at the lowest cost to the taxpayer. It is an important channel for the Federal Reserve's monetary policy. It provides the benchmark risk-free yield curve for pricing risky assets. And it serves as a key source of safe and liquid assets for investors and is used for liquidity risk management by many financial firms, both banks and nonbanks. For all these reasons, and particularly the last one, a well-functioning Treasury market is vital for the stability of the broader financial system.

[1] Treasury Daily Aggregate Statistics | FINRA.org.
[2] US Repo Statistics - SIFMA - US Repo Statistics - SIFMA.
[3] https://www.cmegroup.com/markets/interest-rates/us-treasury.html

To serve these critical functions, the Treasury market needs to be deep and liquid, not only under normal economic conditions but also during periods of high uncertainty and stress. At times of high price volatility, market participants would be expected to pull back from risk taking, and dealers charge higher spreads or are less willing to take large positions. As a result, market liquidity would deteriorate. This type of situation was evident two years ago when two banks failed suddenly—Treasury market liquidity worsened a bit, but markets continued to function.

But at the onset of the COVID pandemic in March 2020, market liquidity deteriorated by much more than expected. In that episode, many types of holders—including open-end bond mutual funds and hedge funds—wanted cash to meet margin calls or to satisfy investor redemptions, and they chose to sell Treasuries, their most liquid securities. But this surge in desired selling exceeded the ability or willingness of dealers to supply liquidity in the face of unprecedented risks and disruptions to normal practices, as many traders were sent to work from home. Treasury prices fell and interest rates rose sharply, especially for off-the-run securities. The sharp rise in rates contrasted sharply with past episodes of high uncertainty when investors fled to the safe haven of Treasury securities and drove down interest rates.

Market functioning was restored only after the Federal Reserve itself began purchasing huge amounts of Treasury securities to provide liquidity. The Fed initially increased its overnight repo operations, announced purchases of a capped amount, but then ultimately committed to "purchase Treasury securities and agency mortgage-backed securities purchases in the amounts needed to support smooth market functioning and the effective transmission of monetary policy to broader financial conditions."[4]

The episode revealed fragilities in the structure of the Treasury market that led to higher interest rates at a time when lower interest rates were needed to support economic activity.

[4] https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm

The Fed purchases of Treasury securities that restored market functioning and lowered interest rates fortunately were aligned with its monetary policy objectives. That is, the purchases came at a time when the Fed was pursuing easier monetary policy to stimulate the economy and get inflation up to its 2% target. It is possible, however, that the Fed may confront the need to intervene in the Treasury market by purchasing securities at a time when this would conflict with achieving its statutory mandate of maximum employment and price stability. Avoiding this possible conflict for Fed policy is important for financial stability and economic prosperity and underscores the importance of regulatory reforms to strengthen Treasury market resilience in stress periods so that Fed intervention is less likely to be necessary.

Structural changes in Treasury markets and recent reform efforts

Treasury market structure has evolved significantly in recent decades, driven in part by regulatory and technological changes as more data have become available and computing power has advanced. One such change is increased electronic trading and how shifting types of market intermediaries have transformed the provision of market liquidity. While traditional dealers had been the main participants in the interdealer cash market, principal trading firms (PTFs) now represent most trading activity in the futures and electronic inter-dealer brokered cash markets. PTFs are generally viewed to have less capital and thus less capacity to absorb shocks than dealers. We saw an implication of these changes in the Treasury "flash rally" on October 15, 2014.[5] And in March 2020, PTF trading volume fell sharply, by more than dealer volumes on the electronic trading platforms.

In addition, the ability or willingness of securities dealers to provide market liquidity was reduced in part by higher bank capital requirements put in place following the Global Financial Crisis (GFC) of 2007-09, and dealer capacity relative to the rise in the amount of Treasury

[5] The flash rally describes when a very large and rapid round-trip in prices occurred almost simultaneously for Treasury securities and derivatives with no apparent impetus. This type of event had occurred in other electronic trading markets, but had not occurred previously in the Treasury market. See https://home.treasury.gov/system/files/276/joint-staff-report-the-us-treasury-market-on-10-15-2014.pdf

securities outstanding has declined.[6] Moreover, the investor base has been changing materially as more price sensitive investors, including private funds with liquidity mismatch or leverage, have increased their holdings, as the share of holdings by foreign official entities, who are less price sensitive, declined. In 2024, money market and mutual funds held more than 16% of total outstanding Treasury debt, and the household sector, which includes hedge funds, held 10%.[7]

In response to these structural changes and evidence of episodic cracks in liquidity, including the 2014 flash rally and the March 2020 market dysfunction, the Inter-agency Working Group on Treasury Market Surveillance (IAWG)—which consists of staff from the Treasury, SEC, Federal Reserve Board, the Federal Reserve Bank of New York, and the CFTC—initiated analysis to support policymakers on possible actions to strengthen Treasury market resilience.[8]

In its 2021 report, the IAWG proposed six guiding principles for public policy in the Treasury markets.[9] At its core, it said that policy should promote a Treasury market where prices reflect the current and expected economic and financial conditions, liquidity in the market is resilient and elastic, and both are underpinned by effective infrastructure, appropriate risk management, and transparency.

The program was laid out in five workstreams. I highlight below some key reforms and what work remains.[10]

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[6] Liang, Nellie and Pat Parkinson (2020), "Enhancing Liquidity of the U.S. Treasury Market Under Stress," Hutchinson Center Working Paper #72, Brookings, December, and Duffie, Darrell, Michael Fleming, Frank Keane, Claire Nelson, Or Shachar, and Peter Van Tassel (2023), "Dealer Capacity and U.S. Treasury Market Functionality," Federal Reserve Bank of New York Staff Reports, no. 1070, August.

[7] TBACCharge2Q32024.pdf (treasury.gov) and Financial Accounts of the United Sates.

[8] The IAWG was formed in 1992 by the Treasury Department, the Securities and Exchange Commission (SEC), and the Board of Governors of the Federal Reserve System (the Federal Reserve Board) to improve monitoring and surveillance and strengthen interagency coordination with respect to the Treasury markets following the Salomon Brothers auction bidding scandal. See U.S. Department of the Treasury, Securities and Exchange Commission, and Board of Governors of the Federal Reserve System, 1992, "Joint Report on the Government Securities Market," U.S. Government Printing Office, January 22. Today, the IAWG consists of staff from the Treasury Department, SEC, Federal Reserve Board, Federal Reserve Bank of New York, and Commodity Futures Trading Commission.

[9] IAWG (2021) report "Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report," November 8, 2021.

[10] A more complete review is in https://home.treasury.gov/news/press-releases/jy2721.

Data quality and transparency. First, the IAWG set out to improve the quality and availability of data on the Treasury market so market participants could better understand developments. In February 2023, the Financial Industry Regulatory Authority (FINRA) began to publish aggregate transaction volume data on a daily basis. Before that, including in March 2020, only average weekly volume data with a lag of a week were disclosed to the public, making it more difficult to understand unusual price movements. A year later, FINRA took a big step and began to disclose daily transaction-level data for on-the-run securities, which represent about one-half of overall daily trading and about 75% of the daily activity in nominal coupon securities. This greater disclosure was implemented carefully to avoid potential harms, such as to confidential positions, by placing caps on trade sizes.

In addition, a new data collection by Treasury's Office of Financial Research (OFR) is closing a large important data gap in the repo market. OFR began collecting data on non-centrally cleared bilateral repo in December 2024. This collection will, for the first time, provide authorities data to monitor a segment of the market that has been opaque since before the GFC, and is where significant risks materialized in March 2020.[11] The new data may represent more than 45% percent of the repo market.

Moreover, the Securities and Exchange Commission (SEC) began collecting more information on hedge funds, such as separate reporting of Treasury cash and derivatives, through improvements in Form PF (filings required by the SEC for private funds). In addition, OFR created an interactive monitor with aggregated data on hedge funds from Form PF and other sources. Recent information from this new Hedge Fund Monitor highlights substantial increases in repo (mostly Treasury) and prime brokerage borrowing in recent years, although leverage increases have been more modest.

[11] Non-centrally Cleared Bilateral Repo | Office of Financial Research and OFR's Pilot Provides Unique Window Into the Non-centrally Cleared Bilateral Repo Market | Office of Financial Research.

Resilience of market intermediation. The second IAWG workstream is to improve the resilience of market intermediation. In 2024, Treasury started a buyback program to support market liquidity by creating predictable opportunities for dealers to sell off-the-run securities to Treasury. While the program is modest in size and not designed to respond to crises, it should free up dealer balance sheets allocated to less liquid positions. Since the launch of the program in May 2024, Treasury has purchased close to $50 billion of securities in 33 liquidity buyback operations, sometimes buying less than the stated maximum depending on the offers received relative to prevailing market prices.[12] Treasury is posting on its website metrics about each operation and is actively monitoring the effects of this program.[13]

In addition, since March 2020, the Federal Reserve has put in place two facilities that should support liquidity in periods of stress, including the Standing Repo Facility (SRF), to finance Treasury repo with pre-authorized banks and primary dealers, and the Foreign and International Monetary Authorities facility for certain foreign central banks. The SRF was tapped in a few instances in late 2024 to relieve quarter-end pressures, indicating initial signs of success by the regulators to reduce possible stigma and make the facility more effective.

The IAWG also suggested that changes could be considered to the supplementary leverage ratio (SLR), a capital rule put in place following the GFC. In contrast to risk-based capital requirements, the SLR requires firms to hold the same amount of capital on reserves at the central bank, which are risk-free, as they would on Treasury securities and on risky corporate debt. When market conditions were stressed in March and April 2020, the Fed temporarily excluded reserves and Treasury securities from the SLR to ease dealer capacity constraints. Since then, market participants and academics have been developing options to change the SLR.

[12] https://home.treasury.gov/system/files/221/TreasuryPresentationToTBACQ12025.pdf.
[13] TreasurySupplementalQ42024.pdf and https://home.treasury.gov/system/files/221/TBACCharge1Q12025.pdf.

One option is to exclude central bank reserves from the SLR calculation, but importantly, with an adjustment to the formula so that there would not be a reduction in the total amount of capital. Avoiding a reduction in capital is important to prevent creating other vulnerabilities in the banking system that could disrupt market functioning in future stress periods. Another option would be to make the enhanced-SLR buffer countercyclical, where the buffer could be released in periods of market-wide stress, based on triggers that are defined ex ante so that banks could plan for a release. On the flip side, the buffer would need to be rebuilt after stresses had eased so that it would be available to be released were market-wide stresses to escalate again. While some adjustments may be appropriate, it would not change the fact that the amount of Treasury debt is much greater than what dealers could intermediate if there were a repeat of the surge of selling that we saw in March 2020.

Excessive surges in demand for Treasury liquidity. A third workstream focuses on reducing the potential for excessive surges in demand for Treasury liquidity in periods of high stress that arise because of some types of investment funds that have high liquidity mismatch and excessive leverage. The SEC proposed a rule to help avoid a repeat of the surge in Treasury sales by corporate bond mutual funds in March 2020, though there was substantial industry pushback because of operational impediments to swing pricing. However, as these funds have grown to hold a significant share of corporate credit, the SEC and the industry should continue to explore possible solutions.

In addition, we saw in March 2020 that excessive leverage in the Treasury market can become destabilizing. Much attention has focused on the cash-futures basis trade, which currently is estimated to be about $1 trillion. This trade involves long positions in Treasury futures by asset managers and hedge funds taking corresponding short positions in Treasury futures and financing their long cash Treasury hedges with repo. This basis trade supports Treasury market functioning in normal times by tying together cash and futures markets and serving as an important source of demand for Treasury securities.

However, the basis trade adds leverage to the ecosystem. Asset managers may buy Treasury futures rather than Treasury securities to meet duration targets, creating synthetic leverage, in order to invest in risky assets to generate a higher return. Asset managers may also prefer futures to repo because futures are less operationally cumbersome, and because they do not require the interest expense reporting that repo does, which keeps reported expenses lower.[14] This accounting distinction should be addressed to reduce the non-economic incentives for futures.

In addition, hedge fund repo positions are levered. Haircuts on bilateral uncleared Treasury repo offered to some hedge funds are reported to be zero. Whether zero haircuts arise because of competitive pressures among dealers, or they are a reporting artifact of dealers managing their risks on a portfolio basis (where zero haircuts are combined with higher margins from the short futures positions), hedge fund leverage in this trade is very opaque and raises concerns about forced position unwinds. The new data on bilateral repo and the move to central clearing should provide regulators further ways to monitor haircuts and leverage and take actions if needed.

Modernizing the infrastructure. Two additional workstreams focus on ensuring efficient and effective infrastructure, recognizing that firms and trading practices have changed significantly in recent decades. The SEC's mandate for central clearing of Treasury securities is the most significant and is potentially transformational to the Treasury market.[15] Central clearing is used for a number of other asset classes, including equities and exchange-traded derivatives. In addition, parts of the Treasury market are already centrally cleared, such as the entire futures market and parts of the cash and repo markets.

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[15] See IAWG (2021) report "Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report," November 8, 2021; Duffie, Darrell (2020), "Still the World's Safe Haven? Redesigning the U.S. Treasury Market After the COVID-19 Crisis," Hutchinson Center Working Paper #62, Brookings, June; Liang, Nellie and Pat Parkinson (2020), "Enhancing Liquidity of the U.S. Treasury Market Under Stress," Hutchinson Center Working Paper #72, Brookings, December.

Expanded central clearing for Treasury securities and repo should increase the intermediation capacity of bank-affiliated dealers because bank capital and leverage requirements recognize the risk-reducing effects of multilateral netting of centrally cleared trades. Combined with increased disclosures on transactions, it may also enable a path forward to some all-to-all trading. On the risk side, central clearing should lead to better risk management by enhancing and standardizing practices. A central counterparty (CCP), for example, could establish margins that better reflect the market risk and concentration of positions rather than just the low-risk nature of Treasury securities. The centralization of transactions also provides greater visibility into market conditions.

The new mandate will lead to a significant increase in the volume of transactions to be centrally cleared. Treasury clearing activity is expected to increase by more than $4 trillion each day, and at least 7,000 new relationships between direct and indirect participants are expected to be needed in advance of the deadlines.[16] The wide set of market participants are actively working to implement the changes, with open issues around market structure, client access models, accounting, and regulatory capital.

A key issue related to the additional significant volume is that there is only one CCP for U.S. Treasuries. But a second firm has submitted an application to the SEC to operate as a CCP and at least one other is considering entering. Entry could lead to greater competition and innovation and bring with it different clearing offerings and pricing, and from a macro perspective, there could be gains to operational resilience from multiple CPPs. These are important potential benefits even as there are some open questions about a loss in netting benefits and fragmentation of liquidity pools when there is more than one CCP.
In addition, multiple CCPs may offer different client access models. The current Treasury market practice for centrally cleared trades is for trade clearing and execution to be bundled together, following a "done-with" model, as dealers have preferred to link the use of their

[16] Treasury Clearing Mandate Survey White Paper | DTCC and U.S. Treasury Central Clearing.

scarce balance sheet with revenues from execution. But there is significant demand for "done-away" models, which are commonplace in other markets with central clearing, namely futures and swaps. In this model, trades executed with one counterparty can be cleared separately through a different clearinghouse member. As such, a big advantage is that it could provide greater competition in trade execution and trade clearing, which would support improved market functioning.

The SEC initially set deadlines for central clearing of Treasury cash securities by year-end 2025 and for repo by the end of June 2026. Market participants are engaged actively but the SEC recently agreed to their request to extend the deadlines by one year. Still, there are interim deadlines, such as for CCPs to implement customer clearing models and to segregate house and customer margins before full implementation.[17]

Conclusion

To conclude, the Treasury and regulators working closely with the industry have made significant progress to strengthen the resilience of the Treasury market. Some important work remains, however, to monitor the effects of reforms and to ensure that others are finalized. Expanded central clearing is potentially transformational to the structure of the Treasury market with significant benefits for resilience. Market participants are working diligently to meet new deadlines but should not be permitted to delay further. Central clearing also could affect how other reforms, such as to address reduced bank-dealer capacity relative to expanding Treasury supply and a growing nonbank sector that relies on Treasury market liquidity to manage its risks, should be formulated. Given the critical role the Treasury market plays and the significant benefits from resilience, it is imperative to continue to execute on the current program, especially as the projected Treasury debt continues to increase.

[17] US Treasury Central Clearing: Industry Considerations Report - SIFMA - US Treasury Central Clearing: Industry Considerations Report - SIFMA and SIFMA and SIFMA AMG Publish Master Treasury Securities Clearing Agreement.