A Challenge for the Next Treasury Secretary: Liquidity in U.S. Fixed Income Markets and Particularly the Treasury Market

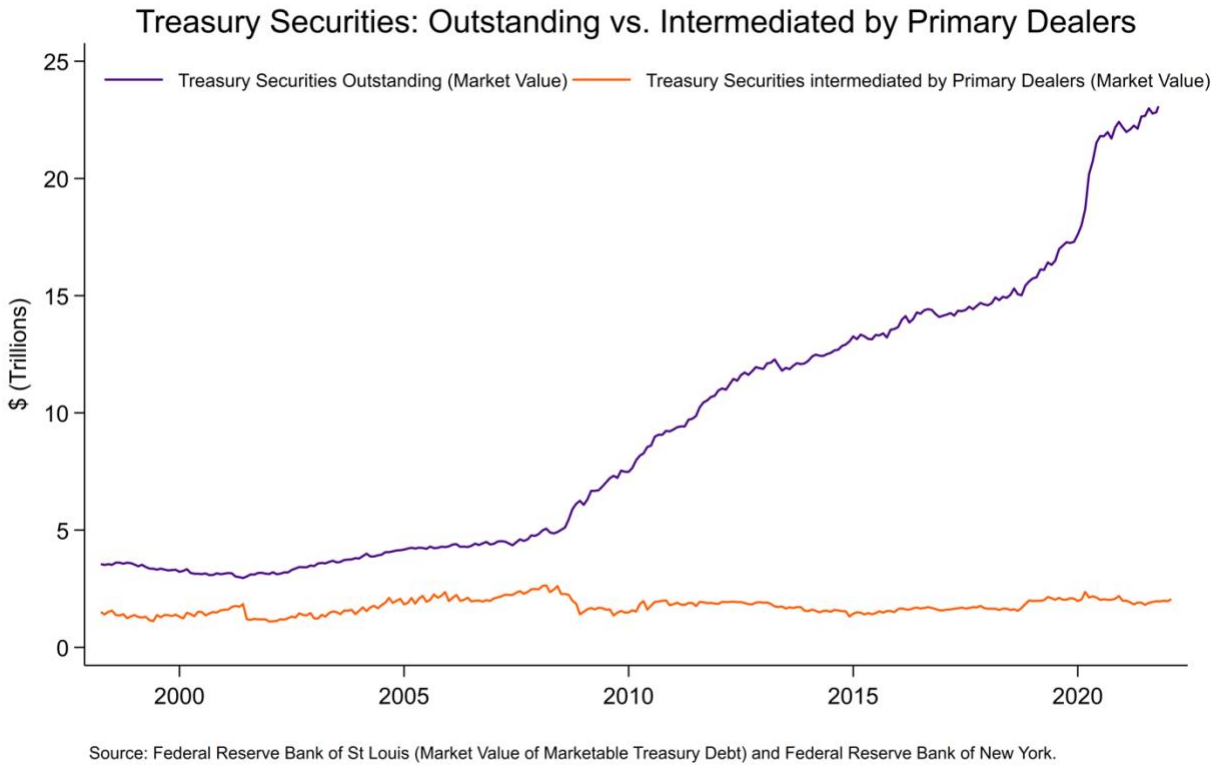
Greg Baer & Pat Parkinson | Nov. 26, 2024

One of the first challenges facing the new Secretary of the Treasury will be to reinvigorate U.S. fixed income markets, most notably the market for Treasury securities that he will be relying upon to finance the government. Market liquidity is fragile; measures to strengthen it have been pending for years; and only politics has stood in the way of their implementation. Cutting that Gordian knot would benefit U.S. economic growth and add resilience to a market that is vital to U.S. interests.

Background

Since the Global Financial Crisis, almost all of the major market makers in securities have been affiliated with banks. Their role is particularly crucial at times of market stress: in normal times, significant market liquidity is now provided by thinly capitalized nonbank firms that employ algorithmic trading strategies, but only for the most actively traded securities; even for those securities, algos lack the capacity to expand their provision of liquidity when a large number of market participants are looking to sell in size.

The lack of market-making capacity is a problem throughout U.S. bond markets, including the U.S. corporate bond markets, which have grown very rapidly in recent years. But the incoming Secretary should have a particular, parochial interest in one vital corner of those markets. Outstanding Treasury securities have increased dramatically, but this increase has not been accompanied by any increase in market making capacity.



Source: Federal Reserve Bank of St Louis (Market Value of Marketable Treasury Debt) and Federal Reserve Bank of New York.

Regulators have been on formal notice of this problem since 2019, when the Federal Reserve was forced to intervene to support the Treasury repo market; it intervened again in 2020 to support all fixed-income markets. On the current path, there is an expectation that the Fed will again have to serve regularly as "market maker of last resort" — a previously unthinkable and wholly inappropriate role for the nation's central bank.

The fragility of the current situation was again demonstrated at the end of the third quarter when broker-dealer balance sheet constraints combined with the settlement of Treasury coupon securities led to a three-day spike in repo rates. The Fed stepped in and increased its repo lending as a partial replacement for the scarce funding from broker-dealers. Such situations are likely to become increasingly common as Treasury financing needs continue to grow.

A Clear and Long-Pending Solution

An effective and immediate solution to this problem is to reform a series of capital requirements that punish the provision of liquidity to the fixed income markets, and particularly the Treasury market.

First, an "enhanced supplementary leverage ratio" now requires most bank-affiliated broker-dealer to hold 5 percent capital to guard against default risk in a Treasury security; their affiliated banks must hold 6 percent. This is the same amount of capital they must hold against a subprime mortgage loan. (As its name suggests, this enhanced requirement is significantly above the standard 3 percent supplementary leverage ratio.) In 2018, recognizing the damage this requirement was doing to market liquidity, the Federal Reserve and the Office of the Comptroller of the Currency proposed to reform the requirement. In April 2020, the Federal Reserve temporarily removed reserve balances and U.S. Treasuries from bank holding companies' SLR calculations. When this temporary relief expired in March 2021, the Fed

announced plans to seek public comment on potential SLR modifications. However, more than three years later, no public consultation has begun.

Second, the Federal Reserve imposes a capital surcharge on Global Systemically Important Banks, or GSIBs, which include all the major U.S. dealers. The methodology for this surcharge is U.S.-specific and deviates significantly from internationally agreed standards, resulting in charges roughly twice as high. This is significant because the GSIB surcharge effectively functions as a market-making tax, since two of its five components are driven wholly by market-making activity, and a third component is largely determined by such activity. Furthermore, numerous other regulations aimed at reducing systemic risk and market-making risk have created redundant risk capture across the capital framework. Once again, the Federal Reserve has long promised to reform the GSIB surcharge but has never acted for fear of political blowback against any action that could be perceived as beneficial to banks.

Third, the Federal Reserve's annual stress test produces a capital charge, and one component of that stress test is a market shock applied to banks that engage in securities dealing. By all evidence, that market shock is unrealistically severe — far more severe than the worst moments of the Global Financial Crisis — and produces a punitive capital charge. To make matters worse, the original (now discredited and discarded) Basel proposal included an additional charge that would have increased capital requirements for this activity by 70 percent.

Distractions and False Remedies

Instead of enacting simple and necessary reforms to capital requirements, policymakers have promoted other measures to restore liquidity to Treasury markets, including greater use of centralized clearing. But recent Fed research indicates that central clearing may not greatly increase bank balance sheet capacity.[1] And hopes that central clearing will lead to all-to-all trading of Treasuries may not be realized.

In any event, access to central clearing most often is intermediated by broker-dealer affiliates of banks that provide clearing services to their clients, and some of the same banking regulations that discourage market-making also discourage client clearing. Indeed, many banks have exited client clearing in recent years, with the cumulative effect that we may now have more central counterparties than banks willing to provide access to those central counterparties. The simple fact is that for now and for the foreseeable future, no capital market— even a market that features all-to-all trading — will be liquid in the absence of market-makers willing and able to put capital at risk during times of stress and that markets that feature central clearing require clearing firms willing and able to intermediate between CCPs and market participants.

The question going forward, then, is whether those market-makers are going to be banks and their broker-dealer affiliates or the government, in the form of the Federal Reserve. It is Kafkaesque that the purpose of capital requirements is to prevent the government (that is, taxpayers) from ever having to support a bank in a crisis, yet the result of current policy is that the Federal Reserve under stress is now trading bonds with taxpayer money.

[1] Bowman, David, Yesol Huh and Sebastian Infante. "Balance-Sheet Netting and in U.S. Treasury Markets and Central Clearing." Federal Reserve Board, June 2024.

A Clear Path Forward

The incoming Secretary of the Treasury will face a lot of difficult and complicated challenges. This is not one of them. A meeting with the head of the federal banking agencies should not be hard to arrange. (The SEC, which is the U.S. regulator of capital markets but has been marginalized by the banking agencies in this area crucial to capital markets, should also be invited to attend.) Eliminate the "enhancement" to the supplementary leverage ratio; make long-overdue adjustments to the GSIB surcharge; and reform the Global Market Shock component of the stress capital charge and eliminate it if and when a market risk charge is added through the Basel process. The result will be good for capital markets, government funding, and U.S. economic growth. And it will come at effectively no cost.

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