

Should we all get to trade Treasuries?

An exhaustive look at the US government bond market structure and why people want to overhaul it



I'm so sorry, I can't help myself

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Last month we wrote about how even mighty Pimco had come out in favour of all-to-all trading in the US Treasury market ([among other things](#)). An even more influential group of people have now come out in favour of it to “strengthen market resilience”.

The Federal Reserve Bank of New York has put out a [paper](#) written by a host of Fed economists and Treasury staffers (and helped by the SEC) that explores the topic. Although typically cautious, the abstract leaves little doubt what they think *should* happen:

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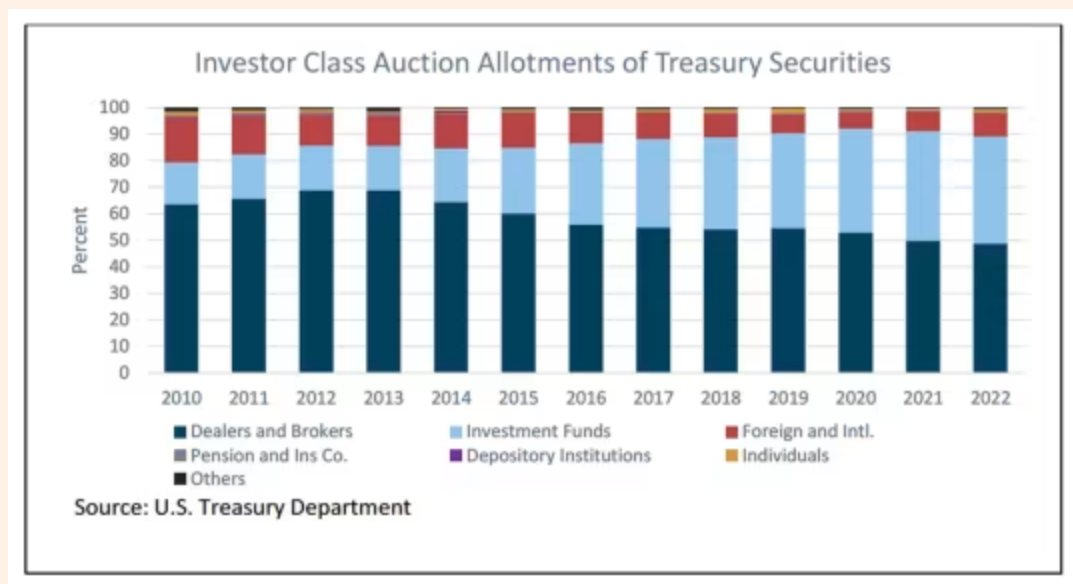
While the U.S. Treasury market remains the deepest and most liquid securities market in the world, several episodes of abrupt deterioration in market functioning over recent years have brought the market’s resilience into focus. The adoption of

all-to-all trading in the Treasury market could be one avenue to strengthen market resilience. Conceptually, all-to-all trading would allow any market participant to trade directly with any other market participant. This could be particularly helpful in times of stress, when the capacity of traditional intermediaries may be tested.

Though there are the usual caveats about this not representing the views of the Treasury or the Fed *yada yada*, it's still very interesting, and comes at a sensitive juncture for the Treasury market.

At the moment, there are basically three separate Treasury markets, which lead to some . . . complications. Skip the next few paragraphs if you're already super-familiar with the US government bond market structure, but for the rest of you this might be a handy (if simplified) guide.

Firstly there is the *primary market*, where new US government debt is auctioned off directly or indirectly via a club of banks known as *primary dealers*. This is basically an all-to-all market now, with non-primary dealers accounting for less and less of the auction allocations in recent years, as the chart below shows.



There's the interdealer *market*, where banks and proprietary trading firms buy and sell on electronic platforms (known euphemistically as "alternative trading systems" through stock market-style, algorithmic central limit order books. In other words, people post their orders to a central platform, and when there's a match money changes hands. On-the-run Treasuries (freshly issued, more liquid bonds) make up most of this, while off-the-run Treasuries (stale ones that trade less often) still mostly trade over the phone.

Then there is a *dealer-to-customer market*, where banks buy and sell Treasuries on behalf of clients like foreign central banks, asset managers, insurers etc. This typically happens through "requests-for-quote", where people ask for bids for securities (through a trading platform like Bloomberg) or by phone, and trades are usually cleared and settled through the Fixed Income Clearing Corp, a central clearinghouse.

The [NY Fed paper](#) has a good breakdown of where Treasury trading happened in the first half of the year.

Table 1: Daily Trading Volume of U.S. Treasury Securities

| Security Type | On the Run | | Off the Run | | Total by Security Type |
|---------------------------|-------------------|--------------------|-------------------|--------------------|------------------------|
| | ATS & Interdealer | Dealer to Customer | ATS & Interdealer | Dealer to Customer | |
| Notes and Bonds | \$265.1 B | \$154.4 B | \$40.5 B | \$86.8 B | \$546.8 B |
| Bills | \$12.9 B | \$21.8 B | \$20.2 B | \$61.0 B | \$115.8 B |
| TIPS | \$3.0 B | \$4.8 B | \$1.2 B | \$5.6 B | \$14.6 B |
| FRNs | \$0.1 B | \$0.4 B | \$0.1 B | \$0.9B | \$1.5 B |
| Total by Segment | \$281.1 B | \$181.4 B | \$61.9 B | \$154.4 B | |
| Total by Seasoning | \$462.5 B | | \$216.3 B | | |

Source: Authors' calculations, based on data from FINRA TRACE.

Notes: The table reports average daily trading volume of U.S. Treasury securities in billions of dollars between January 3 and June 30, 2022). When-issued trading activity before securities become on-the-run is excluded from the figures.

However, while this model has worked pretty well, there are more and more signs of it beginning to break down — [sometimes dramatically](#).

First of all, there's just a helluva lot more Treasury bonds around these days, with the volume growing from about \$5tn in 2007 to almost \$24tn at the [end of last month](#).

At the same time, bank prop trading desks were shuttered after the financial crisis, and their market-lubricating desks are constrained in how much inventory they can carry. Meanwhile, the influx of high-frequency proprietary trading firms (HFTs or PTFs) have “changed how market liquidity is provided and influenced the characteristics of that liquidity”, the NY Fed paper notes.

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Traditionally, dealers buy and sell from customers in large amounts, hold a portion of these positions across days, and maintain a large balance sheet to support their positions. In contrast, PTFs buy and sell frequently in the interdealer market and typically end the day with relatively small net directional exposure on a risk-adjusted basis. Many PTFs are able to operate with less capital than typical broker-dealers due to their more limited net exposure and because they are not subject to the same regulations as broker-dealers. PTFs tend to make trading decisions primarily based on immediate or near-term profitability and the level of market risk and do not typically maintain strong client relationships. PTFs also prefer to transact in more liquid securities, such as on-the-runs, where there is more data availability and transparency, along with electronic trading protocols that allow

them to use automated trading strategies. High concentration among PTFs has resulted in a small number of PTFs playing a key role in price discovery and the provision of market liquidity. Increasingly, some dealers have also adopted similar electronic and high-frequency trading strategies.

The idea behind all-to-all trading is to embrace a more equity-style trading ecosystem where everyone can trade with everyone else anonymously and on the same footing.

This intuitively makes a lot of sense. If BlackRock wants to sell Treasuries and Pimco wants to buy they can do so directly without having to go through JPMorgan? If Citadel Securities or Jump Trading can provide better pricing than Citi, why shouldn't they be enabled to do so directly to customers? If some banks are forced to retreat in a crisis, then shouldn't other market participants be allowed to step into the breach?

Here's what the paper concluded:

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Trading protocols are continuing to evolve in the Treasury market and trading platforms are introducing new ways of transacting. Additionally, the types of institutions that trade in the Treasury market are shifting and new entrants are altering the landscape of trading further. Finally, the regulatory landscape is changing, with the official sector making progress towards its objective of enhancing the resilience of the Treasury market. Treasury market structure innovations — such as all-to-all trading — which could expand or deepen new avenues of trading, — could also serve to enhance the Treasury market's depth, liquidity, and resilience.

The NY Fed paper points out that for all-to-all trading to develop, the Treasury market probably needs more central clearing (taking out counterparty trading risks) and more transparency. [Pimco notably opposed both of these](#), because the former would increase costs, and the latter make banks less willing to intermediate big trades.

But honestly, FTAV cannot see how clearing and transparency can be avoided if this is the intended direction of travel?

However . . . It has to be noted that all-to-all trading is not a silver bullet that will fix all the Treasury market's challenges. In fact, some people think it might even make things worse.

For example, it could make liquidity more dependent on high-frequency traders and thus more procyclical, with tighter bid-ask spreads in normal times but shallower depth in torrid times.

Yes, banks do not altruistically throw their balance sheets to prevent markets from falling, but

Yes, banks do not voluntarily throw their balance sheets to prevent markets from falling, but even the smaller ones have more capital to play with than even the biggest HFTs.

Liquidity-wise, it is less-traded Treasury securities — like off-the-run bonds and inflation-linked notes — that are the *real* problem, and they actually make up most of the overall market. Shifting to an all-to-all model might not help them much.

It won't be easy to implement either. Primary dealers are still the essential engine of the Treasury market, and will fight tooth and nail against this. Moreover, retooling the US government bond market is a huge and not entirely risk-free task. Given its systemic nature in terms of funding the US government and underpinning the global financial system, tinkering with the Treasury market's structure is a bit like trying to fix a jumbo jet mid-air.

As the paper stressed:

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... Challenges remain to broader use of all-to-all trading. For example, most trading protocols in the U.S. Treasury market that offer access to a broader range of trading partners are limited to trading of on-the-run or near on-the-run notes and bonds, while less liquid parts of the market may have a greater need for the benefits all-to-all could provide. Additionally, we found that most Treasury market trading platforms that offer these trading protocols are legal counterparties to the trades executed over their platforms, which can create unclear and complex clearing and settlement risks with the platform itself and contribute to broader financial stability risks in the market. Finally, market structure changes always have the potential to affect the competitive landscape of a market, so the possibility that certain market participants could alter their activity in the Treasury market were all-to-all trading to become more broadly used must be carefully considered.

Still, the sense that big changes could be afoot is almost palpable.