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Regulators Look to Lessen Treasury Market Reliance on Big Bank Dealers

Fed and Treasury Department have been on alert about the stability of the $24 trillion market

By Andrew Ackerman Follow *and Jon Hilsenrath* Follow

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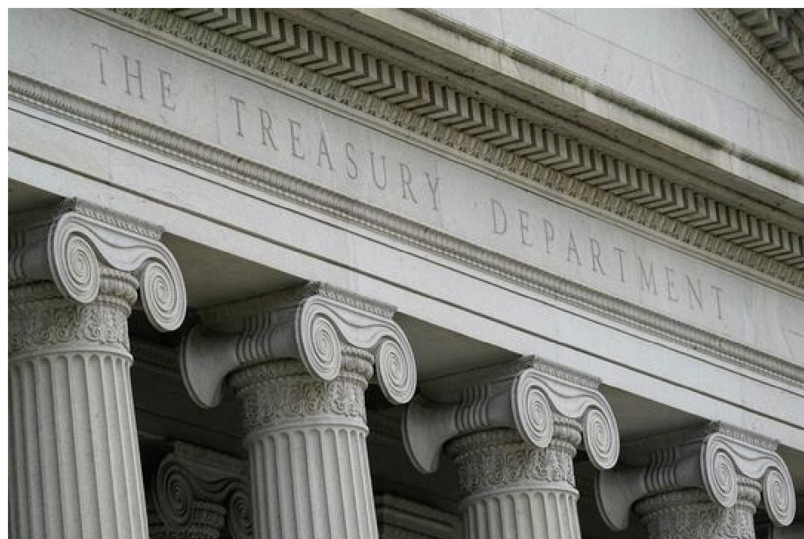
Regulators are looking to broaden trading in the immense $24 trillion market for U.S. Treasury securities, a potential power shift away from the small club of big banks that have dominated the market for decades, according to a federal report released Thursday.

Regulators have been on heightened alert about the stability of the market since March 2020, when Covid-19 disrupted the economy and markets, freezing up trading in Treasury securities. Recent volatility in the Treasury market has added to concerns.

U.S. government bonds are the bedrock of the global financial system. In addition to the sheer size of the market, and its role in financing U.S. budget deficits, many financial institutions use Treasury securities as collateral for loans of other kinds. Erratic moves in the market can thus ripple out widely to other markets and can affect interest rates that consumers pay on mortgages or car loans.



In recent months, officials have noticed that Treasury markets have grown less liquid and become more volatile.

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Thursday's report from top regulators—including the U.S. Treasury, Federal Reserve, Securities and Exchange Commission and Commodity Futures Trading Commission—shows regulators are interested

in supporting the growth of "all-to-all"' trading.

That is a concept in which buyers and sellers would trade Treasury securities directly with each other rather than rely on big banks. For instance, large mutual funds or insurance companies might swap securities directly, rather than using banks as middlemen. Some other markets use similar trading practices; for example, it exists on a small scale in corporate bond markets and in many derivatives markets.

U.S. officials emphasized that they are still in the early stages of examining the benefits and costs of a push toward all-to-all trading. A conference hosted by the New York Fed next week will partly focus on the idea. Such trading requires an infrastructure in markets to make it possible, such as common legal agreements or a central clearinghouse through which buyers and sellers would clear trades, so any change could take years to develop.

"In theory, all-to-all trading may improve market liquidity by increasing the number and diversity of potential counterparties to a trade or reshaping the competition among them," the regulatory report states. "All-to-all trading may also offer increased transparency."

A separate report published last month by the Federal Reserve Bank of New York further highlighted the interest of regulators. All-to-all trading, it said, "could be particularly helpful in times of stress, when the capacity of traditional intermediaries may be tested."

Neither Thursday's report nor the New York Fed's report envisions the government establishing an all-to-all platform or mandating the use of one. Instead, officials have signaled that some steps they are already considering—such as more transparent pricing and centrally clearing more transactions—could over time encourage more all-to-all trading. The SEC in September proposed more central clearing of Treasury trades.

That month, portfolio managers at bond giant Pacific Investment Management Co. argued that the role of dealer intermediaries makes the Treasury market more fragile and less liquid. In a report, they said policy makers should use their clout to press for an all-to-all system "in which all market participants are able to trade with each other, bypassing the dealers in some cases."

Primary dealers, a group of about two dozen large global institutions, now play a central role in the U.S. government's efforts to sell its securities. The dealers—which include the trading operations of Barclays PLC, BCS **0.80%** ▲ Citigroup Inc., C **0.85%** ▲ Credit Suisse Group AG, CS **-3.19%** ▼ Goldman Sachs Group Inc., GS **-0.15%** ▼ JPMorgan Chase JPM **0.98%** ▲ & Co. and other big global banks—are obligated to bid at government debt auctions and distribute securities they buy.

"It's unfair to expect the same liquidity providers to be able to provide the same liquidity levels when the Treasury market has more than doubled in size but not seen any real innovation in the last twenty years," said Chris Concannon, president and chief operating officer of MarketAxess Holdings Inc., which

operates an all-to-all trading platform in the secondary market for Treasurys that it launched earlier this year.

Treasury debt held by the public has grown from less than $4 trillion in 2002 to $24.4 trillion as of this week, according to the Treasury. More than $600 billion of Treasurys trade hands on average each day, according to data collected by the Securities Industry and Financial Markets Association, an industry group. Primary dealers are involved in the vast majority of such transactions, research by the New York Fed has found.

“I am sure the dealers will fight back,” said Thanos Bardas, global co-head of investment-grade fixed income at Neuberger Berman, an asset-management firm. “You can’t expect them to show up and bid in the auctions and then, on secondary trading, to reduce their influence.”

Mr. Bardas added that he would be surprised if all-to-all trading performed better than the current setup at a time of market stress. Among other options, he said, he would prefer rule changes that made it easier for banks to hold more Treasurys on their balance sheets.

Regulators set up an interagency group to monitor the Treasury market in 1992, when investment bank Salomon Brothers was found to be breaking auction bidding rules. In recent years, regulators have grown concerned that trading in Treasury markets has become less seamless and more prone to disruption.

Treasury Secretary Janet Yellen leads a group of regulators charged with oversight of financial stability in the U.S.
PHOTO: AL DRAGO/BLOOMBERG NEWS

One case was a “flash crash” in October 2014, when Treasury yields tumbled and then recovered in a few minutes of trading without an obvious catalyst. In mid-September 2019, repo markets, which depend on Treasury securities as collateral, experienced unusual volatility in a short period of trading. Then Treasury markets froze in March 2020, when Covid-19 struck the economy and financial system.

One concern is that the capacity of the big banks to hold securities themselves hasn't grown as much as the Treasury market. Since the 2007-2009 financial crisis, new federal capital and liquidity regulations have restrained the growth of bank balance sheets.

In recent months, officials have noticed that Treasury markets have grown less liquid and become more volatile. One consequence of these developments is that relatively small trades are causing bigger changes in bond prices and yields than had been the case before.

U.S. securities regulators don't think they can buffer against calamitous events like a pandemic, but they say they are trying to strengthen the underlying market by making it more transparent and taking other actions to ensure more widespread access to the market.

Big banks have argued that regulators should ease the capital requirements associated with their Treasury holdings. That would allow them to play a bigger role in the market, the banks argue.

"If you want to increase marketwide capacity, regulatory recalibration is where you will get the most bang for your buck, particularly in stressful times," said Rob Toomey, managing director and associate general counsel of Sifma, the industry group.

The Fed allowed a temporary, pandemic-related reprieve from capital requirements in question to expire last year, while promising to propose a broader revamp. It has yet to do so. Thursday's report doesn't mention the issue.

Another challenge facing regulators is that the Fed's own campaign of raising short-term interest rates to combat inflation is a factor causing volatility in Treasury markets. If volatility in the market became extreme, Fed officials might be placed in the difficult position of having to decide which problem to make a priority: fighting inflation with rate increases or tamping down volatility that the rate increases are helping to cause.

Something like that happened in September in the U.K., when the Bank of England intervened to contain the fallout of a furious bond-market selloff that threatened U.K. financial stability.

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