Testimony of Ira Jersey

For the U.S. House of Representative's Financial Services Committee Task Force on Monetary Policy, Treasury Market Resilience, and Economic Prosperity.

This testimony is my work alone. Although I am Chief US Interest Rate Strategist for Bloomberg Intelligence (BI), a research division of Bloomberg LP, these views are mine alone, and not necessarily those of Bloomberg LP or any of its employees.

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Chairman Lucas, Ranking Member Vargas, and Members of the Task Force, I appreciate the opportunity to discuss with you potential changes in financial regulations that may enhance the liquidity of the most important market in the world – U.S. Treasuries. Recent events have highlighted that liquidity in this market can sometimes be fragile. For over a decade I've highlighted there is often an illusion of Treasury market liquidity, that vanishes during high volatility periods. In fact, in December 2014, I wrote that Treasury market liquidity had become fickle – which hasn't changed and may have become somewhat worse.

The key points of my testimony today include:

1. Market volatility is not unusual, and while some recent intraday moves have seemed unusual, they are not in a longer term historical context;
2. Rules and regulations designed to reduce the risk of institutional and market failure have also created an environment where market-making type activities have not been able to keep pace with the growth of the Treasury market;
3. Enhancing Treasury market liquidity will require the reshaping of many financial rules. For example, I believe exempting Treasuries from the Supplementary Leverage Ratio is a positive step for market liquidity, but by itself isn't enough to quell potential market illiquidity.

Treasury Market Liquidity Unparalleled, Yet Volatility Still Likely as Capital Rules Impede Balance Sheet Elasticity

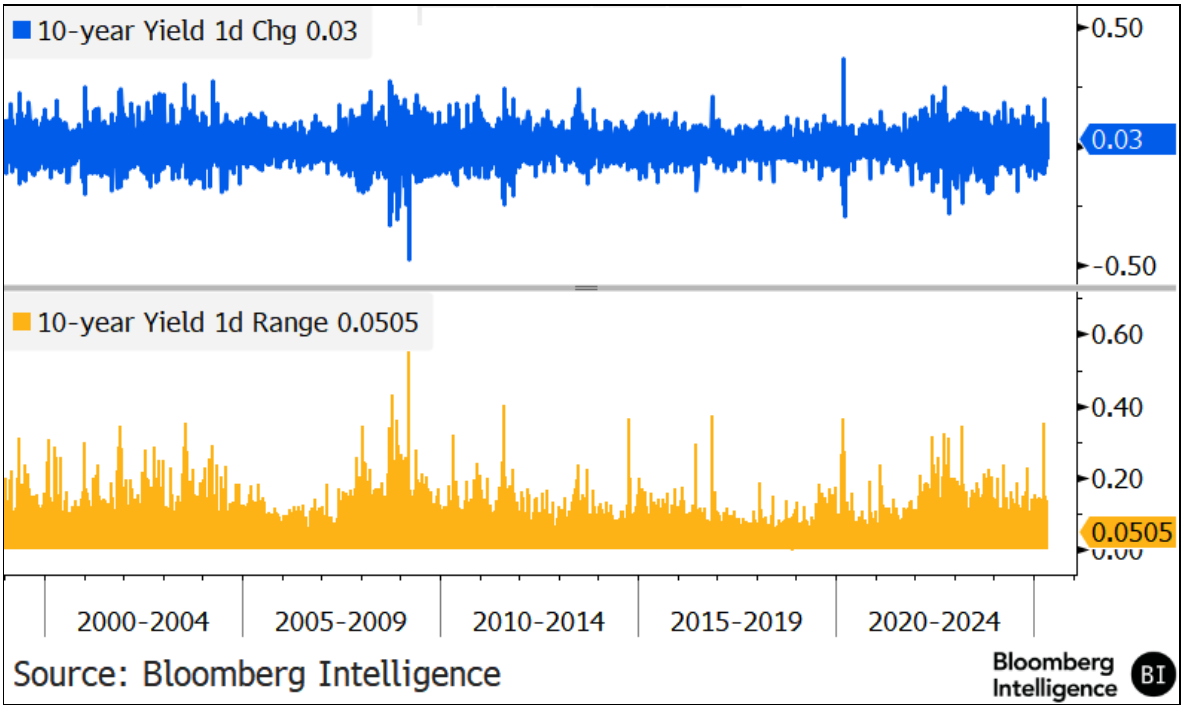
When discussing Treasury market fragility and methods to mitigate these risks, we need to start by defining liquidity. If it's defined as the ability transact on demand at a low cost (ie tight bid/offer spreads) without large price moves, then the US Treasury market is by far the most-liquid bond market in the world. But at times liquidity can be illusory, in that the market is very efficient during normal times, but there can be periodic interruptions. During periods of one-way trading, prices often fall or jump swiftly.

Financial regulations may need to balance the need for safe and robust financial institutions, while allowing market-makers and other financial intermediaries to provide liquidity based on the market environment.

Since 2013, fears of declining Treasury market liquidity have risen, particularly since the 2014 flash rally and the implementation of the Basel bank capital rules and Dodd-Frank financial regulations. These rules and regulations created sound financial institutions, but the flip-side is less flexibility within the overall financial system. Effectively there was an unintended trade-off that occurred: the risk of additional market volatility was exchanged for sounder financial institutions. This is a trade-off that policymakers could embrace, as market volatility is less costly for taxpayers than complex workouts of financial institutions.

Treasury market volatility isn't unusual in a historical context (Figure 1). Even before the 2007-2009 Global Financial Crisis, Treasury yields regularly traded in broad ranges similar to today.

Figure 1: Volatility Is Fact of Life Even in Liquid Markets



There isn't a single rule or change that will suddenly and permanently increase Treasury market liquidity, and these rules aren't confined to dealers or banks; they also include mutual-fund liquidity rules, central counter-party margin requirements, and insurance company regulations, among many others. Among these, changes to bank capital rules may have the lowest barriers to amend.

Many bank capital regulations were implemented following the 2007-2009 Global Financial Crisis, some of which work at odds with each other. These rules seem to have incentivized some of the largest banks to maximize capital utilization, leaving little room to expand market-making operations or provide leverage to clients like hedge funds, which might otherwise be willing to take advantage of relative-value opportunities amid volatility.

Figure 2: Large Bank Basel Capital Regulations

Metric	Brief Description	Primary Constraint
Leverage Ratio	Global non-risk based measure of leverage that includes on and off balance sheet exposure, requiring capital to be held against assets	Assets/Equity
Supplementary Leverage Ratio	US specific non-risk based measure of leverage that includes on and off balance sheet liabilities, including derivatives, secured financing (repo), and untapped revolving loans	Assets/Equity
Enhanced Supplementary Leverage Ratio	Stricter version of the SLR for the largest, most important US financial institutions	Assets/Equity
Liquidity Coverage Ratio	Measure to protect against bank deposit outflows by mandating minimum high quality liquid asset holdings to meet a modeled 30-day outflow scenario	Assets
Net Stable Funding Ratio	Requires bank liabilities (funding) come from stable sources over a longer time horizon such as sticky deposits and longer term debt, vs short term wholesale borrowing	Liabilities
TLAC Requirements	Requirement for the largest, most important US financial institutions to protect taxpayers from bailout costs by shifting losses to equity and debt capital investors	Equity/Liabilities
Risk Weighted Capital Ratio	Amount of equity capital banks need to hold against their assets, weighted by the risk of those assets. Risk of default, maturity risk, and operational risks are considered.	Equity/Assets

Source: Bloomberg Intelligence

Bloomberg Intelligence

Robust and Elastic Funding Markets Enhance Trading

Unlike many other global sovereign bond markets, Treasuries enjoy a deep and easy means to fund transactions for short term trades - primarily in the repurchase agreement market. In recent years, the repurchase agreement innovation known as sponsored repo, which allows dealers to net fund trades that are cleared through the Depository Trust & Clearing Corp. (DTCC). Since late 2022, the use of sponsored repo has climbed to more than 70% of the market used to make up the secured overnight-financing rate (SOFR). Counter-party limits and regulatory shifts such as delays in central clearing, have slowed the growth of this market since late 2024.

About 80% of dealer trades are on-the-run securities and includes 60% of funding need. Since most of these trades can't be netted, dealer balance sheets can easily get constrained by funding and the 40% of off-the-run securities. Since late 2022, the use of sponsored repo has climbed to more than 70% of the market used to make up the secured overnight-financing rate (SOFR) (Figure 3). Counter-party limits and regulatory shifts such as delays in central clearing, have slowed the growth of this market since late 2024.

Before the financial crisis, the repurchase-agreement market was larger than the amount of Treasury notes and bonds outstanding. The repo market size surged from the mid-1990s following implementation of the first round of Basel bank capital rules. In the mid-2000s, when realized rate-market volatility was low, relative-value investors did highly levered trades between Treasury instruments. Some securities were reportedly rehypothecated (reuse of collateral) multiple times, eventually triggering a major unwind of trades and more fails in funding markets (Figure 4).

Today's rules take the opposite approach. The net stable funding ratio (NSFR), for example, precludes banks and their dealer arms from expanding their balance sheets quickly to balance market supply/demand dynamics. Limits should be kept, but there may be room for flexibly.

Figure 3: Sponsored Repo Helps But May Have Reached Limit

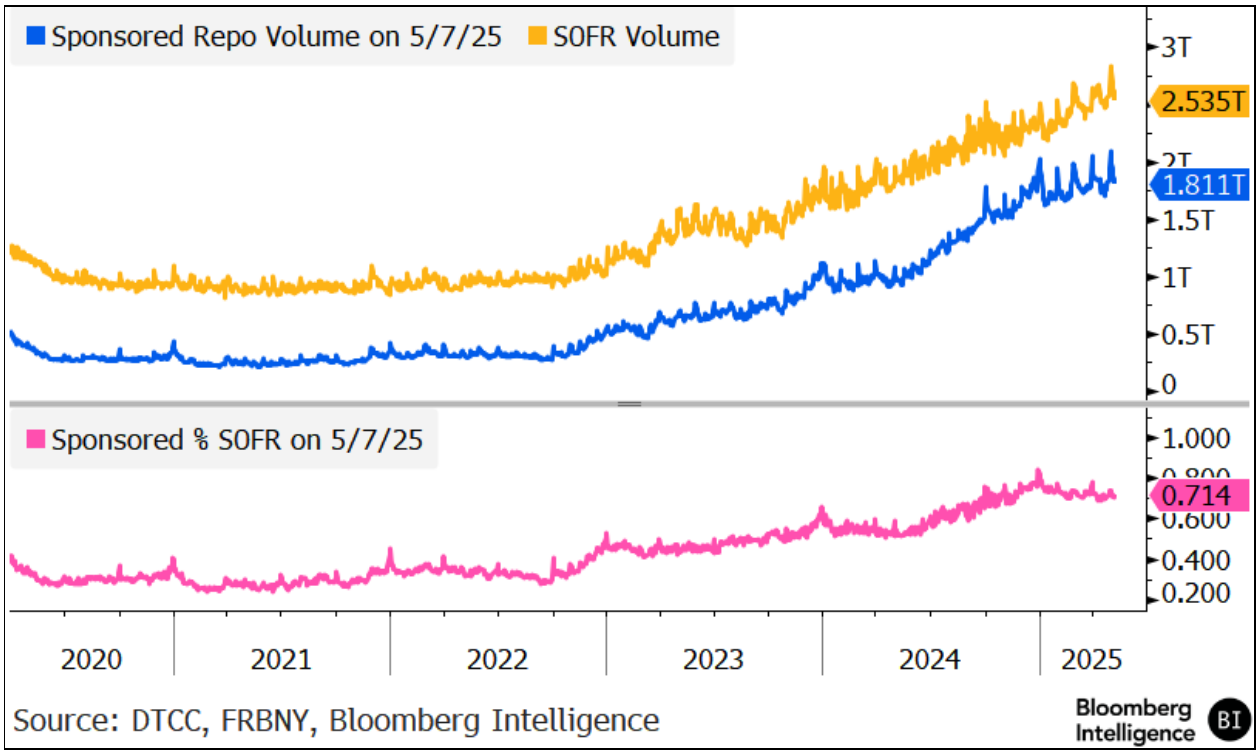
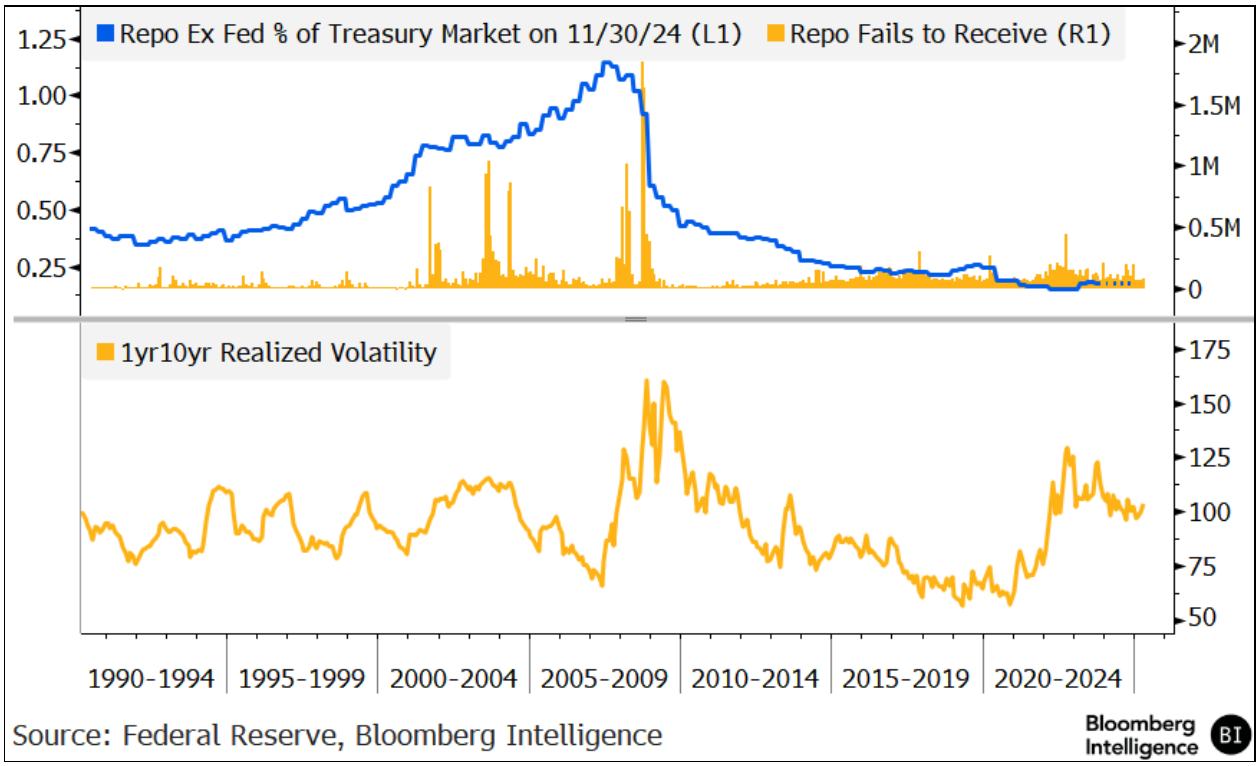


Figure 4: Repo Market Share of Treasury Has Declined

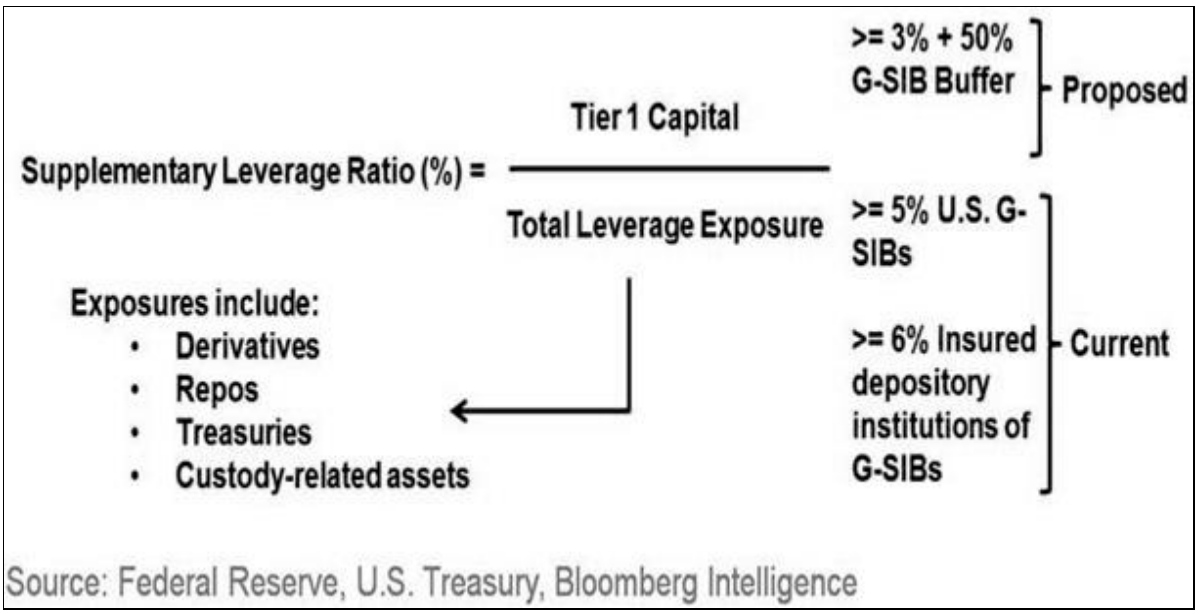


SLR Shift Incremental Help, Dealer Risk Review

An often-touted regulatory change is to exempt Treasuries from the calculation of the enhanced supplementary-leverage ratio (SLR) for systemically important banks. Such a change would incentivize banks to own more Treasuries per unit of equity capital, but other rules would continue to limit the ability of banks and their dealer arms to fund these positions. Other leverage ratios, the liquidity-coverage ratio (LCR), and the net stable-funding ratio (NSFR) are among other limits on how large bank and dealer Treasury positions might become.

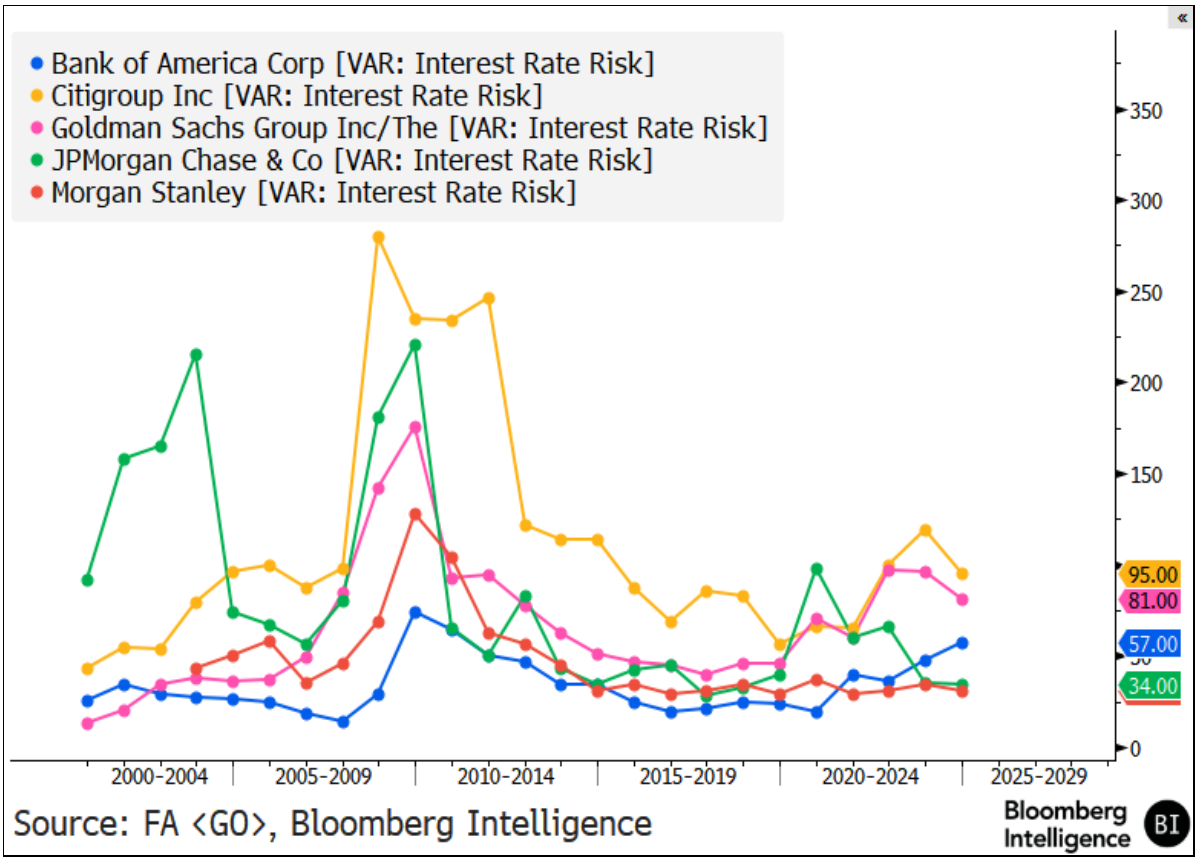
Even exempting Treasuries from all these rules wouldn't have the desired effect. For every asset owned by a financial institution, there is an offsetting liability. Repurchase agreements and other non-deposit funding remains constrained by capital rules.

Figure 5: Proposed eSLR Changes



Several banks have increased interest-rate risk over the past few years, but others have maintained relatively low rate exposure in general (Figure 6). The ability to hedge interest-rate exposure by using levered instruments such as futures and interest-rate swaps are an important factor creating a robust and deep rate market. The recent failures of Silicon Valley Bank and Sovereign Bancorp were in part triggered by inadequate interest-rate hedging, but these weren't due to the lack of instruments to hedge this exposure.

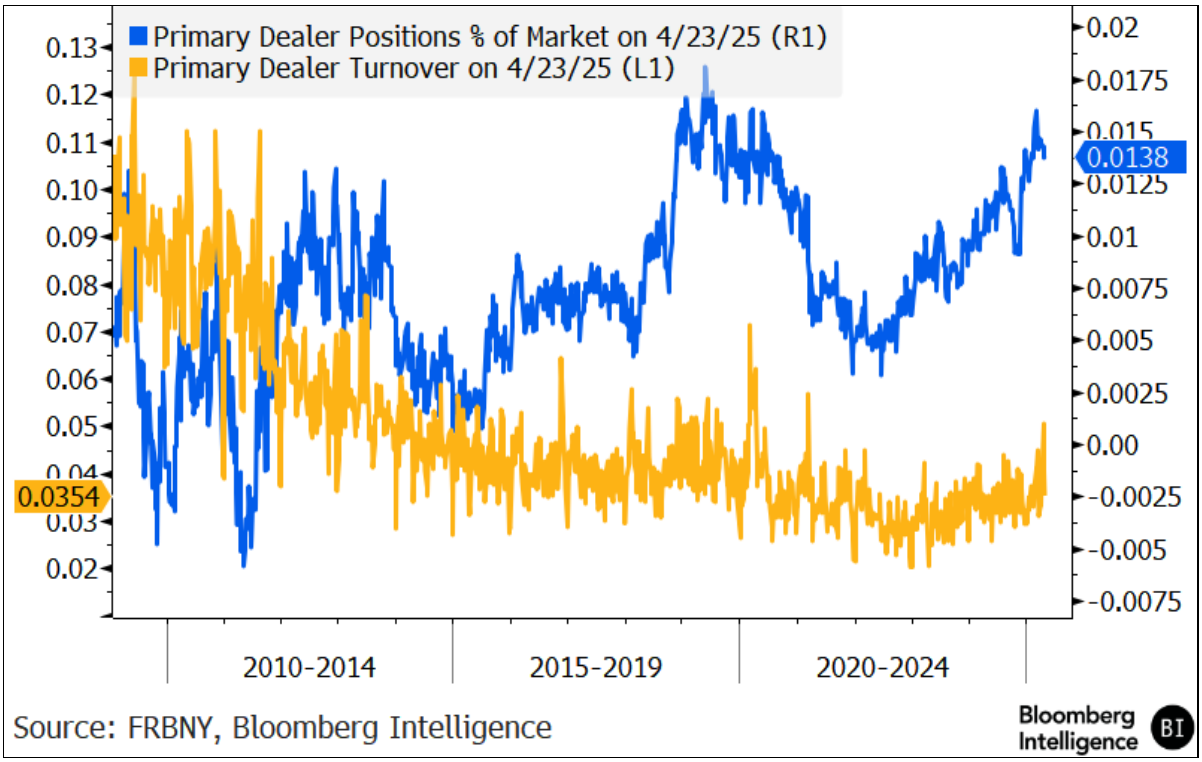
Figure 6: GSIB Interest-Rate Risk Remains Contained



Dealer weekly trading is about 3% of the market, down from 7% during the financial crisis (Figure 7). With the size of the Treasury market now some 400% larger than it was in early-2009, without similar increases in dealer balance-sheet capacity. Other structural shifts in the market, however, also reduce the need for dealer participation outside of stressed periods, particularly high-frequency traders (HFTs) that trade for their own book and provide liquidity, but often pull back when volatility increases. In 2019, the New York Federal Reserve estimated 21% of Treasury activity was from these firms (see link left), which likely has increased at the expense of dealers since that time.

This is a reason why there's a illusion of liquidity; markets are very deep most of the time, but market depth dries up swiftly when volatility increases.

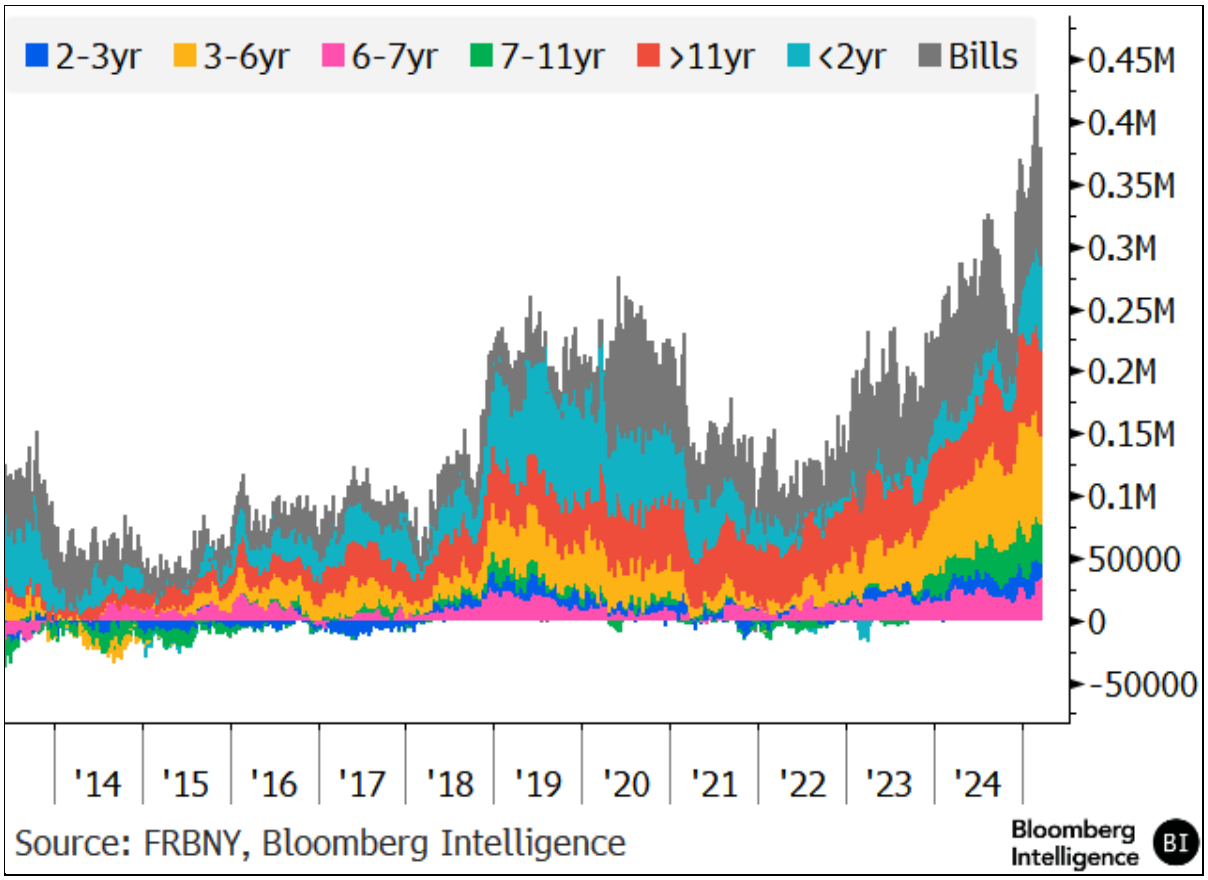
Figure 7: Dealer Turnover and Positions Share of Market



Dealers added to Treasury positions following large selloffs in 2021 and 2022. When dealer positions become large, incremental additions and market-making activity during times of volatility may be more difficult. Given the near record notional value and risk (read DV01) of dealer balance sheets going into early April, it's not surprising that volatility ensured as headlines drove investors to swiftly shift positions (Figure 8). Market action during overnight hours can also be constrained by lack of intermediaries available to take risk. Asian trading desks tend to have smaller risk limits than in London or New York.

"All-to-all" trading might not generate the liquidity and mitigate the volatility that some hope. When markets become one-way, bids are pulled swiftly. High-frequency traders, for example, step away during high-volatility periods.

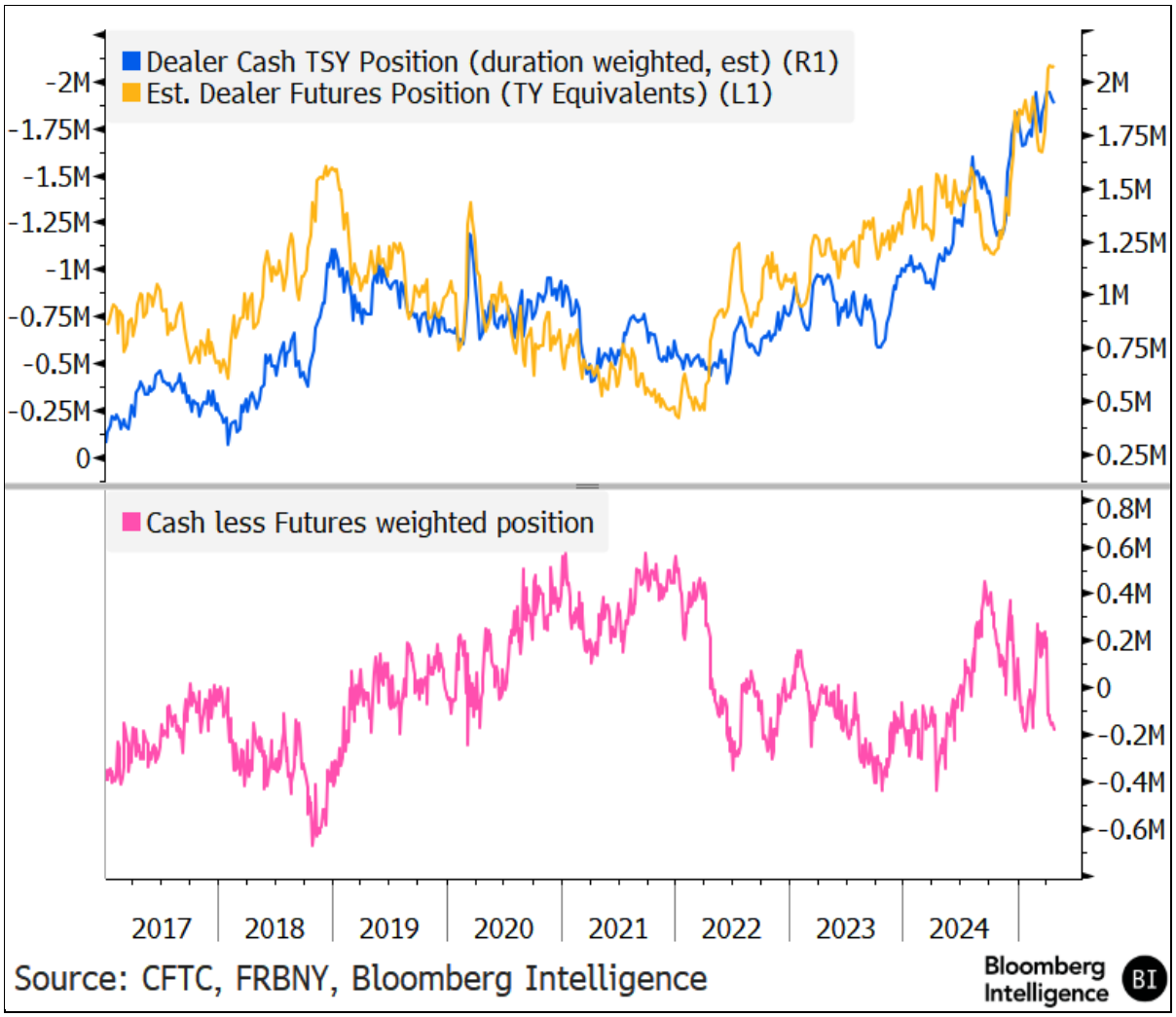
Figure 8: Dealer Positions in Cash Treasuries



Shallower market depth and wider bid-offer spreads always accompany bouts of increased market volatility, yet financial-sector balance sheets matter for the extent that liquidity declines. Dealers, in particular, might still find it difficult to expand balance sheets in times of stress. Since late 2023, dealers have added to cash Treasury positions as they shorted Treasury futures.

A means to help dealers step into volatile markets would be to ease capital requirements in times of extreme market volatility. The rule would need to have triggers that become effective when certain intraday volatility thresholds are met, and would need to be at the discretion of the dealer to be effective. This "volatility backstop" would need to be sufficient for dealers to hold Treasures though funding via the repurchase-agreement market.

Figure 9: Dealers Forced Into Basis Trade as Hedge to Cash

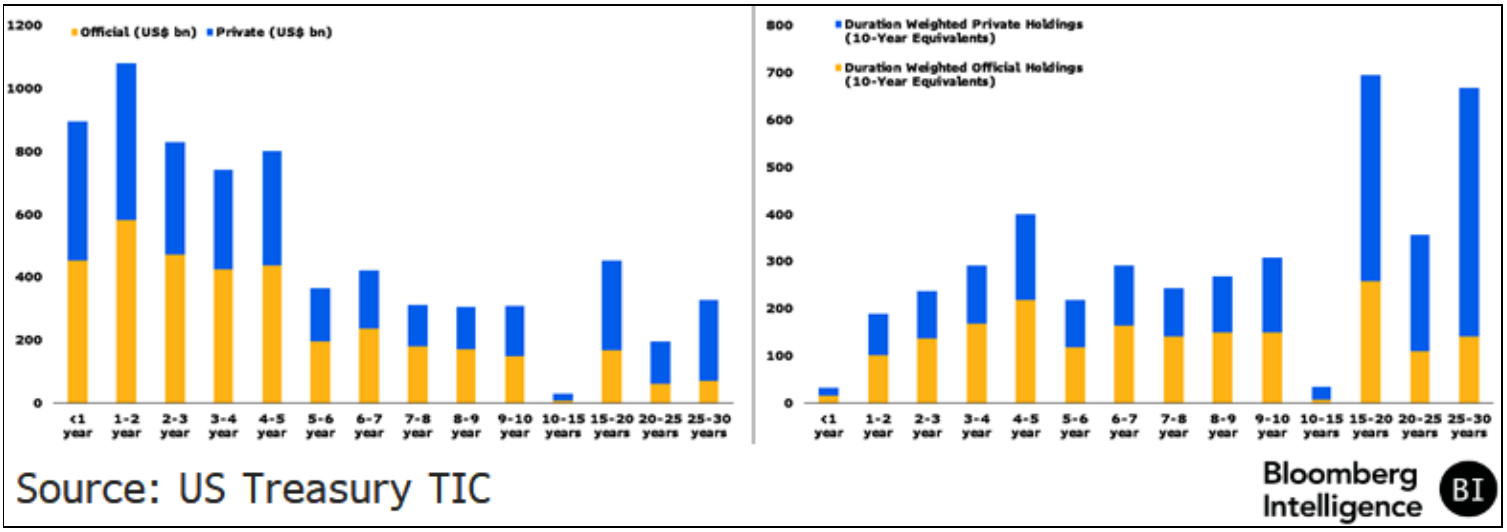


Private Foreign Investors Own Most Treasury Risk

Foreigners own about 31% of Treasury securities totaling $8.8 trillion dollars. A bit more than half are held by foreign private investors for investment purposes. This is a major shift since 2010, when nearly three-quarters of foreign held Treasuries were held by official institutions (primarily foreign-currency reserve managers and sovereign wealth funds). The uptick in private purchases corresponds with US Treasuries yielding more than other debt after hedging the currency exposure. Therefore, if currency-hedging costs shift, so might the willingness to hold US Treasuries.

Although private and official ownership of shorter-term securities is about equal, private investors own much more long-maturity bonds. Once this debt is risk-weighted for duration, private investors own much more risk than official institutions.

Figure 10: Foreign Treasury Ownership by Maturity: June 2024

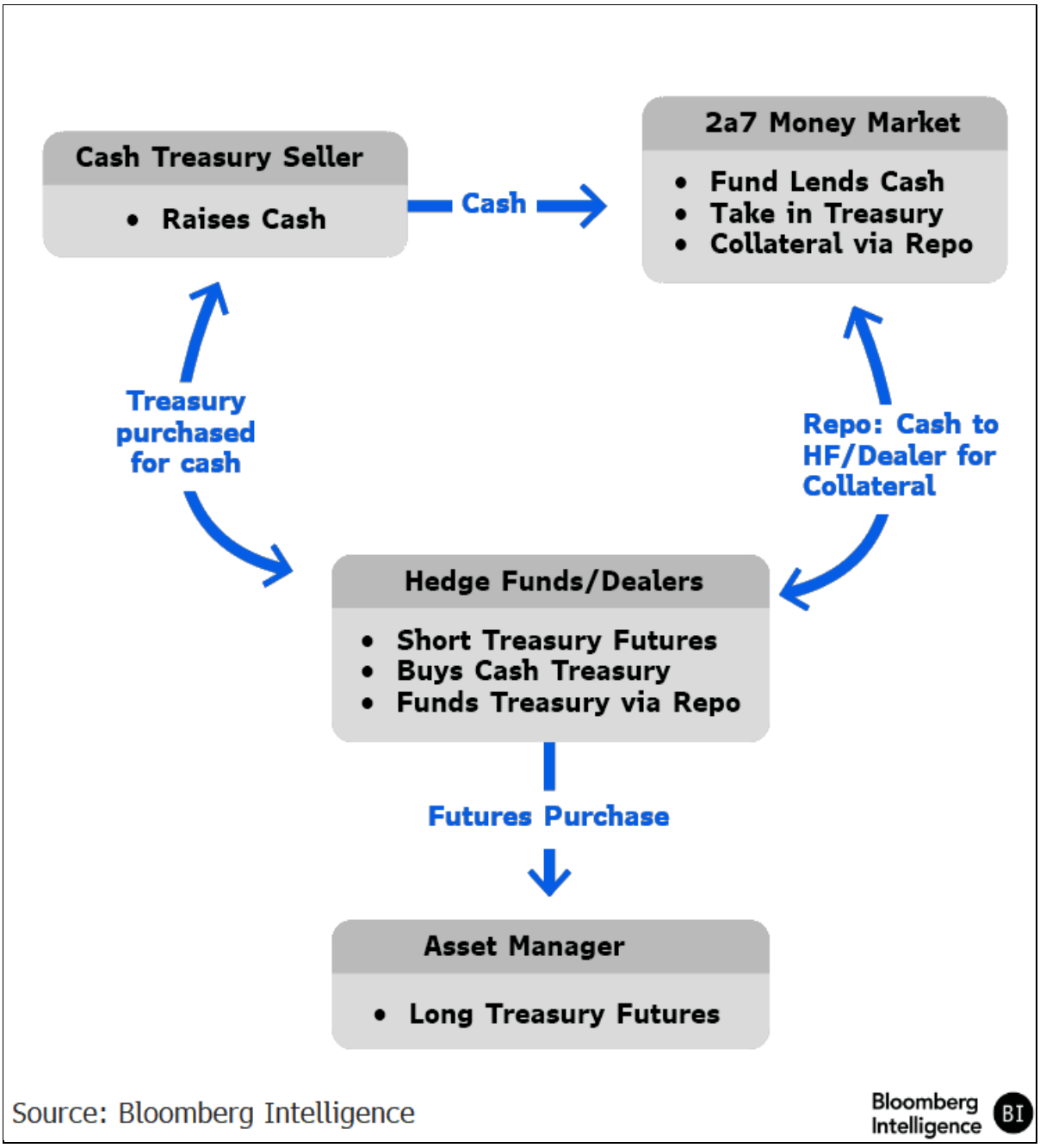


April Treasury Volatility Not Due to Futures Basis Trade Unwind

Some are scared that Treasury futures against cash securities basis trades could be exacerbating volatility in the market, something we think hasn't occurred. If there's such an unwind, it would have several noticeable market effects. First, cash securities would be selling off vs. futures (they aren't). Second, open interest in contracts where the basis trade is known to be large would be falling swiftly (they aren't). Third, money funds would likely be reducing their reliance on repo and using the Federal Reserve's RRP facility to a greater extent (RRP facility usage has fallen).

The exhibit is a simplified anatomy of a cash Treasuries vs. futures basis trade. In a traditional basis-trade unwind, you'd expect all three outcomes to occur in some meaningful magnitude.

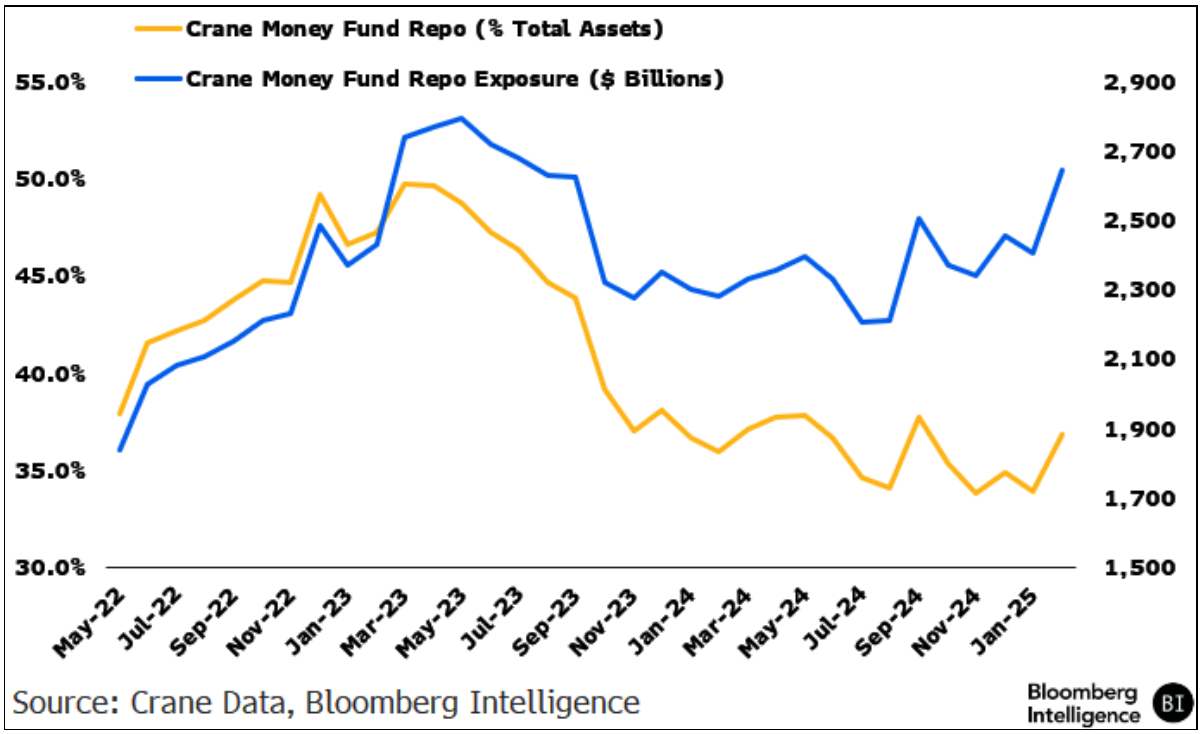
Figure 11: Anatomy of Traditional Basis Trades



A decade ago, most rule 2a7 money-market mutual funds were incentivized to move to be government-only funds, investing in Treasury bills, GSE discount notes, and repos collateralized by government securities. This has led to over one-third of money-fund assets being in repos -- or nearly $2.7 trillion. Money funds are able to lend their cash to dealers and hedge funds to facilitate levered long Treasury positions. If basis trades were unwinding, with levered longs selling cash securities, one effect would be a decline in repo by money funds.

Money fund managers would respond by purchasing T-bills or using the Fed's RRP facility. It's not clear there's been an uptake in T-bills by 2a7 funds, and the RRP facility use has actually declined the last week. In fact, indirect take of last week's T-bill auctions was unremarkable.

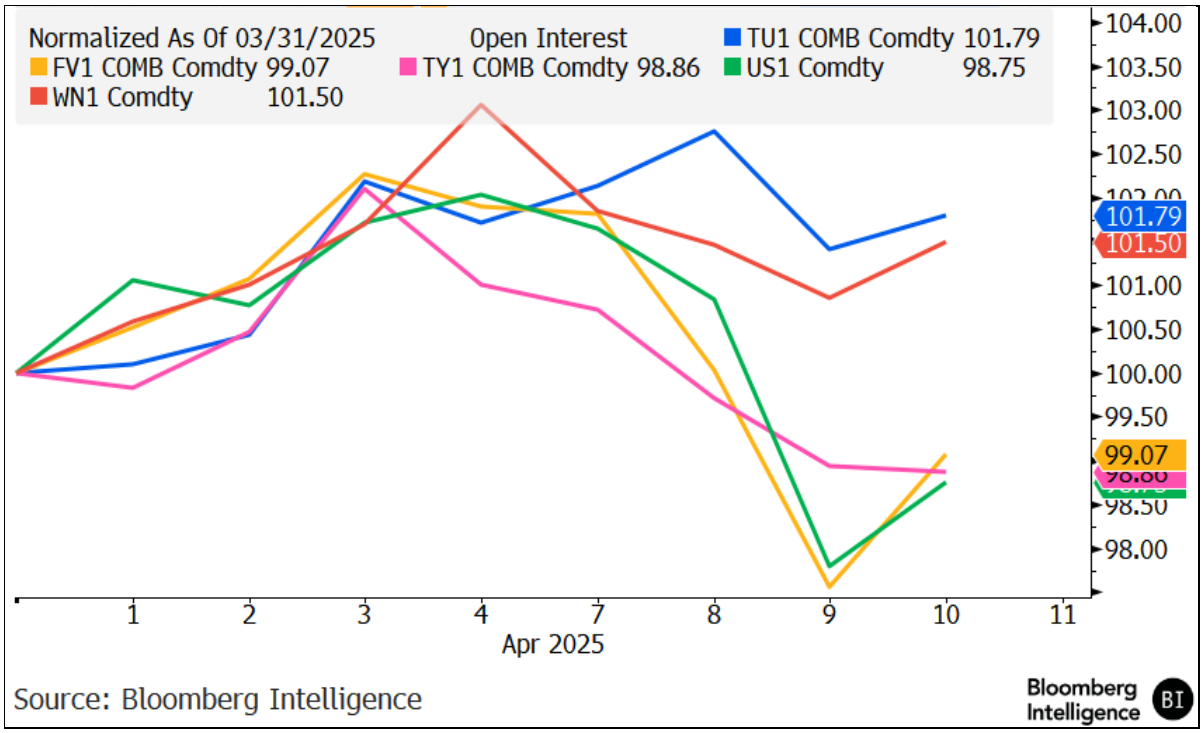
Figure 12: Money Funds have $2.7 Trillion in Repo Market



If the futures basis trades were being unwound in any systemically important way, the open interest across the Treasury futures complex would be reduced far more drastically than it has been through the April 10 close. If levered participants are "long" the basis, they are short Treasury futures, and long the underlying cash Treasury. The unwind of this trade would see large futures buying to cover the existing short, and a reduction of open interest as the trades are closed out -- not to mention the hit to funding markets.

Given the prevalence of basis activity in two- (TU), five- (FV), and 10-year (TY) futures, the relatively sharp reduction in 5-year activity highlights some pressure, but the move's magnitude was fairly benign. Some of the reduction was likely due to stop-outs given the pronounced intraday volatility.

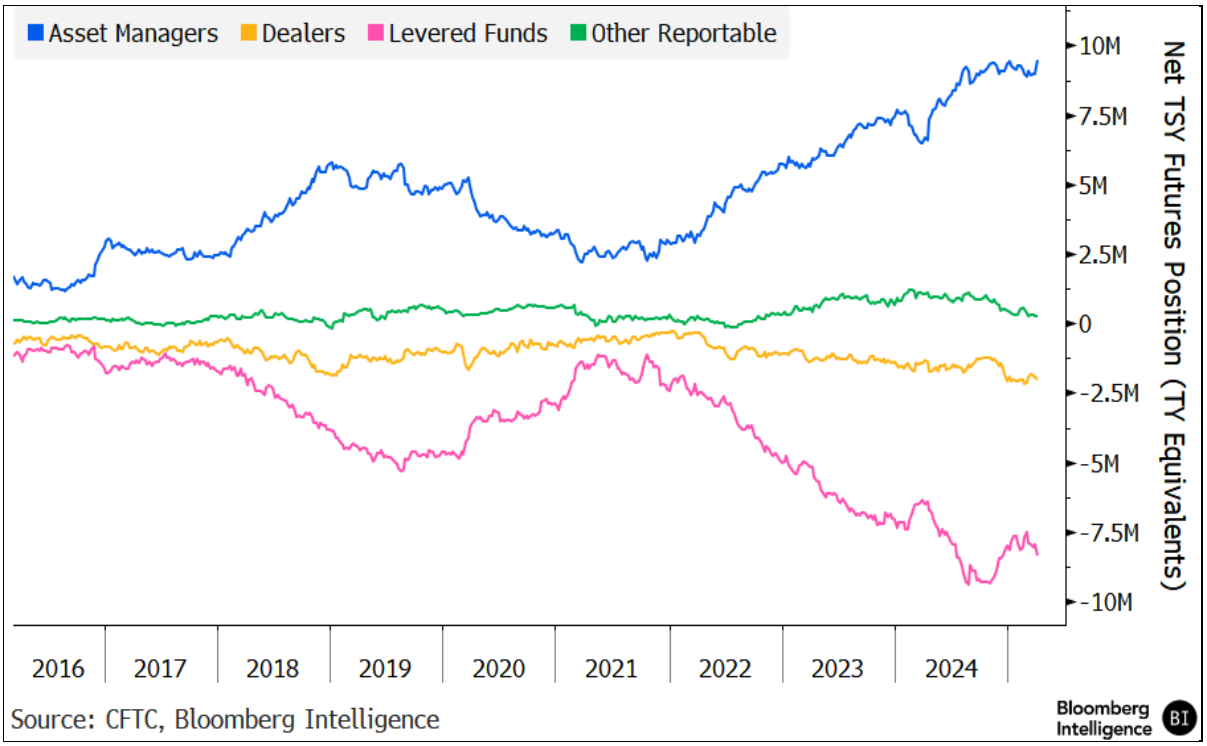
Figure 13: Futures Open Interest Hasn't Declined Much



Cash-Futures Basis Is Created by Asset Managers

Regulators often point fingers at basis traders, which is unsurprising given the inherent leverage and inability to monitor the underlying funding market. However, they are merely economic actors exploiting a profitable opportunity -- one created by the outsized demand for Treasury futures vs. cash Treasuries from asset managers. Broadly, asset managers use Treasury futures given the balance-sheet efficiency and liquidity, as well as their embedded leverage. Repo is far less common than futures as a source of leveraged duration exposure, due to potential mandate constraints and flow-through to expense ratios. This creates excess demand for futures, richening them relative to the deliverable cash-Treasury. As delivery dates approach, the basis decreases, as the underlying Treasury and future price coalesce.

Figure 14: Net Treasury Futures Exposure by Participant-Type



The recent research report by Brian Meehan, from the Bloomberg Intelligence fixed income market structure team, notes that swap spreads are where the action has been. We add that it's both swap spreads and Invoice Spreads (the swap rate less implied Treasury-futures yield). Because traditional basis trades haven't unwound (yet), it appears that swap-spread widening positions have been liquidated. Prior to last week's extreme volatility, most had thought (and seemingly positioned for) swap spreads to widen toward minus 50 bps as the regulators prepared to exempt Treasuries from the supplemental leverage ratio (SLR), thereby increasing Treasury demand, and reducing reliance on swaps to get long exposure.

As the long end of the yield curve sold off last week, there appear to have been limited payers of swaps causing the tightening.

Figure 15: Invoice Spread and Swap Spreads Have Been Linked