

Testimony of

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Prosperity  
Of the Committee on Financial Services  
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Mr. Chairman, Ranking Member Vargas, and Members of the Task Force, thank you for inviting me to speak with you today. Ensuring adequate intermediation capacity for the Treasury's future debt issuance is an extremely important financial stability issue, and I am grateful for the Task Force's attention to this topic.

My name is Susan McLaughlin, and I am an Executive Fellow and Lecturer in the Practice of Management at the Yale School of Management's Program on Financial Stability. Before my appointment at Yale, I worked at the New York Fed for 30 years in a series of operational, policy and management roles in which the primary dealers were my key counterparts. My views reflect my experience on the trading desk ("the Desk"), but my testimony today is based entirely on information in the public domain.

#### The problem: ensuring sufficient intermediation capacity for Treasury debt

As has been widely documented, the quantity of marketable Treasury debt is growing faster than the dealer community's capacity to intermediate it, and is projected to continue growing. In the near term, several policy measures in effect or in train are likely to augment intermediation capacity and resilience in the short- to medium-run, by relieving pressure on dealer balance sheets.

- The Treasury's buyback program, launched last year, allows primary dealers to sell illiquid securities back to the Treasury before maturity.
- The changes to the enhanced supplementary leverage ratio recently finalized by the federal banking agencies is expected to free up some balance sheet room for the six G-SIB-affiliated primary dealers who are the largest intermediaries in the market.
- The SEC's Treasury clearing rules, which will take effect in 2026 (cash) and 2027 (repo), are expected to greatly expand the scope for balance sheet netting.

Taken together, these measures are likely to add at least several trillion dollars of intermediation capacity to the market. But when one considers that the quantity of Treasury marketable debt outstanding grew by \$1 trillion just between July and October 2025, this may not suffice in the longer term.

The Committee has asked, could adding more primary dealers help? Should we open up the list to additional types of firms? I will return to these questions, but will first provide some important background on the role primary dealers play in both monetary policy implementation and Treasury debt underwriting.

#### The original role of the primary dealers: monetary policy implementation

Primary dealers have always served as trading counterparties in the market operations the Desk conducts to implement monetary policy decisions of the Federal Open Market

Committee. In this role, they assume a number of obligations that have costs to the firm. They must participate consistently and competitively in the Desk's operations in a variety of market environments. They must provide the Desk with ongoing market intelligence and analysis to support the formulation and implementation of monetary policy and the monitoring of Treasury market conditions. They must assume a number of operational responsibilities in support of the Desk's business continuity planning.

Primary dealer designation also yields some benefits that offset these costs. Many investors will only transact with primary dealers. Primary dealers have access to the Fed's standing repo facility as a source of liquidity when needed; they alone can borrow Treasuries from the Fed's securities lending program. And at least twice in this century, in 2008 and again in 2020, primary dealers have had access to an emergency liquidity backstop in extreme market stress events, given the critical role they play as intermediaries in the U.S. government securities market.

#### Extension of primary dealer role to support the stability of U.S. Treasury auctions

Historically, the New York Fed has designated the largest two-way intermediaries in the Treasury market as primary dealers because they provide the greatest operating capacity for the Desk's operations. These firms are also some of the largest bidders at Treasury auctions. Thus, there has to date been a high degree of overlap between the Fed's needs for counterparties with large-scale transaction capacity in the secondary market and the Treasury's needs for large-scale underwriting capacity in the primary market. Over time, as fiscal agent, the New York Fed has leveraged the primary dealers to support Treasury issuance as well as monetary policy operations.

Expectations for primary dealer support of Treasury issuance have also evolved. Beginning in the mid-1980s, primary dealers were explicitly required to participate "meaningfully" in all auctions of U.S. government debt. More recently, since the New York Fed revised its counterparty policy in 2016, primary dealers have been subject to an explicit requirement to bid for their pro-rata share of the amount of Treasury debt in each and every auction. In other words, today's 25 primary dealers must each submit bids equal to or greater than 1/25<sup>th</sup> of the amount of securities being sold at each auction. The pro-rata share requirement is designed to ensure that no Treasury auction ever fails by requiring the primary dealer community to collectively place bids equal to the entire amount to be auctioned. The rare instances in which a primary dealer fails to meet its pro-rata share requirement are taken very seriously by New York Fed and firm management alike. Repeated failure to meet the pro-rata requirement is grounds for suspension or even revocation of a firm's primary dealer designation.

Competitive auctions are not limited to primary dealers. The Treasury's auction rules allow a wide range of market participants to bid, if they have the required operational arrangements in place. But only primary dealers are subject to the pro-rata requirement.

#### Who can become a primary dealer?

The Federal Reserve Act does not prescribe the types of firms that may serve as counterparties to the Fed's monetary policy operations. Counterparty decisions are part of the operational responsibility the FOMC delegates to the New York Fed for the implementation of monetary policy. To date, the largest market makers have generally been regulated banks and broker-dealers; eligibility is limited to these types of firms.

Having provided that background, let me come back to two questions I was asked to discuss.

#### Should we have more primary dealers?

Since the primary dealer system was formed in 1960, there has never been an explicit target number of primary dealers that was viewed as "optimal". Rather, the number of primary dealers has fluctuated over time, reflecting changes in market structure and other global economic and financial market developments. For example, the number of primary dealers grew during the Japanese economic boom in the 1980s, as a number of Japanese banks became global in scope and set up dealerships in the Treasury market. The number subsequently fell in the late 1990s and early 2000s, amid rapid consolidation in the U.S. banking and broker-dealer sectors. The number of primary dealers contracted further with the failures and mergers of several banks and securities firms during the global financial crisis. While there are currently 25 primary dealers, the number has ranged from a peak of 46 in 1988 to a low of 17 in 2008.

After the global financial crisis, I led work at the New York Fed to assess the extent to which additional firms beyond the primary dealers might augment the Desk's operational capacity and resiliency. From 2013 to 2014, we conducted a pilot program in which several smaller broker-dealers participated in Treasury purchase and sale operations along with the primary dealers. In 2016, we published a new counterparty policy that set out revised eligibility criteria for primary dealers, using the experience from the pilot program. The revisions were meant to widen the scope of eligible firms, while still ensuring that all primary dealers would have a sufficient presence in the Treasury market both to participate meaningfully in the Fed's operations and to bid for their pro-rata share of securities in each Treasury auction. Specifically:

- The minimum net regulatory capital requirement for broker-dealers was reduced from \$150 million to \$50 million.

- The minimum gross Tier 1 capital threshold for banks and branches was updated to better align with the new requirement for broker-dealers, to support equitable treatment of both types of firms.
- A minimum Treasury market share requirement of 0.25 percent was implemented to ensure that dealers eligible under the reduced threshold had a sufficient market presence to support both Desk operations and Treasury issuance. This market share metric applies to both primary and secondary market activity.

Several additional primary dealers have been designated since these changes in eligibility criteria were published.

From a Treasury market resilience perspective, the key reason to add more primary dealers is to increase the set of firms subject to the pro-rata bidding requirement that mitigates the risk of failed auctions. All else equal, more primary dealers means broader support for auction coverage and a lower requirement for each individual firm. But the marginal cost of adding another primary dealer is not zero. As is true for any market participant, time and resources are required to evaluate, onboard and manage one's trading counterparties.

The New York Fed has not published any further changes to its primary dealer policy since 2016. This may not mean that additional reviews have not been done since then. But given the growth in Treasury issuance over the past decade, additional study to determine whether there are additional non-primary dealer firms with a market-making presence large enough to warrant designation, and any implications for eligibility criteria, would be helpful—if this work has not already been done. It is also important to note that not all eligible firms choose to become primary dealers; for some, the costs I have outlined may outweigh the benefits.

#### Should the primary dealer system be opened to other types of firms beyond banks and broker-dealers?

Primary dealers are crucial to the Desk's ability to implement monetary policy precisely because they can buy or sell in all sectors of the Treasury yield curve, in size, in all market environments. Therefore, I do not recommend expanding the primary dealer designation to any firm that is not in the business of making two-way markets in Treasuries. Such firms are not fit for purpose as Desk counterparties; their addition risks impairing the efficiency and stability of the Desk's monetary policy operations.

We may be approaching a level of Treasury debt at which the Treasury's and Fed's needs no longer overlap as perfectly as they once did. If steps were needed in future to augment auction coverage, for example, they might need to be decoupled from

counterparty management for monetary policy implementation. Could Treasury consider designating a new tier of counterparties solely to support auction coverage in such a scenario? This is a matter for the Treasury to determine. But Treasury has already taken a step in the direction of establishing non-primary dealer counterparties by announcing that buyback operations will be opened to some non-primary dealer firms in 2026.

### Concluding thoughts

It is sensible to periodically assess whether additional firms could productively be designated as primary dealers to support the dual objectives of monetary policy implementation and Treasury auction coverage, and whether changes to the primary dealer policy are warranted. But I would not recommend designating firms that are not two-way market intermediaries. Doing so would add little to capacity, while posing risks to the efficiency of monetary policy implementation. If the pro-rata requirement were to become increasingly difficult for primary dealers, requiring identification of additional auction participants that could help to support coverage needs, this strikes me as a fiscal matter that could be considered separately from the central bank's responsibility for monetary policy implementation.

Moreover, these measures may offer less potential to augment capacity than changes to the structure of the Treasury market would. Central clearing, for example, is likely to relieve some of the pressure on dealers' balance sheets by increasing the scope for balance sheet netting. Another innovation in market structure that I have not mentioned so far that could also help to reduce pressure on dealer balance sheets is all-to-all trading. In all-to-all trading, buyers and sellers can transact directly with each other rather than through a dealer. This is not yet happening in the Treasury market, though there are some all-to-all platforms in other markets such as the corporate debt market.

In the long run, the greatest risk to the resilience of the Treasury market, and the global financial system that Treasury debt anchors, is the level of the national debt itself. If the growth in the debt continues unchecked, there will be a point at which none of the solutions I've mentioned will be sufficient to support adequate intermediation capacity. The level of the debt is the first-order problem to solve. But in the meantime, we should continue to explore all avenues to support the market's capacity to intermediate Treasury debt, given this market's importance to the U.S. economy, the U.S. dollar's role as the world's reserve currency, and global financial market stability.

Thank you for the opportunity to be here today to discuss this important financial stability issue.