Testimony for the House Committee on Financial Service's Task Force on Monetary Policy, Treasury Market Resilience, and Economic Prosperity

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I appreciate this opportunity to appear today before this Committee on the topic of examining Treasury market fragilities and preventive solutions. The Treasury market, US financial regulation and financial institutions have been a focus of mine through many roles over the last 20 plus years including as a financial economist in the US Treasury's Office of Debt Management, associate director for financial institutions policy at the Office of Financial Research, a vice president with responsibilities related both to bank supervision and monetary policy at the Federal Reserve Bank of Dallas, and associate managing director for US bank ratings at Moody's Investors Service.

Today I will focus on the Treasury market, the Federal Reserve's use of unconventional monetary policy and financial institution regulation, highlighting areas where I believe reforms both are and are not needed to strengthen Treasury market resilience and promote US financial stability.

I would like to make **three big picture points** today.

First, **bank deregulation is an ineffective solution to Treasury market fragility.** Indeed, reducing the amount of capital that banks hold against US Treasuries when Treasury market volatility is rising and stagflation is on the horizon is inconsistent with sound risk management and robust economic growth, instead increasing risks of a costly US financial stability event.

Second, **the Federal Reserve's use of unconventional monetary policy both has contributed to unsound fiscal policy and been destabilizing to the US banking sector.** The Federal Reserve, the Administration and Congress should recognize that the overuse of unconventional monetary policy unintentionally has contributed to a worsening of the nation's finances.

Finally, **we urgently need to run a more responsible fiscal policy – attempting to strengthen "Treasury market resilience" through bank deregulation and/or reliance on unconventional monetary policy are the wrong tools for the job.**

Turning to my first point – bank deregulation is an ineffective solution to Treasury market fragility. Both the Biden and Trump Administrations have been attracted to proposals to remove Treasuries from remaining large US banks' supplementary leverage ratios (SLRs) in the hope that such an action will promote greater "Treasury market resilience."[1] Some in the US banking industry have also begun to advocate for changes to the risk-based capital surcharge for the most systemic US banks, or G-SIB surcharge, stating that it also is acting as a "unnecessary brake" on US banks' holdings of Treasuries. Finally, some advocate that the Tier 1 leverage ratio, which is a regulatory requirement that impacts all US banks, be reexamined, arguing that it "incorrectly" constrains bank investments in Treasuries.

[1] The 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) already removed Treasuries from the supplementary leverage ratios (SLRs) of the three large US custody banks.

Financial regulation needs to be consistent in its focus on promoting sound financial institution risk management. Eliminating bank capital requirements for US Treasuries when Treasuries are exhibiting heightened price volatility is inconsistent with sound risk management.

Unfortunately, the history of financial regulation includes periods of financial repression. What is financial repression? It is when governments implement regulatory policies to channel funds to themselves. Does financial repression sound farfetched? It is useful to remember how banks' existing risk-based capital standards came into being. Following the Great Depression, US bank supervisors focused on banks' capital to total asset ratio, effectively a leverage ratio. Following the end of World War II, risk-based capital standards were developed and facilitated US banks' substantial purchases of government securities which were granted a zero-risk weight, requiring no capital.

After World War II, US government debt to GDP was similar to current levels – roughly 100% of GDP. At the time, even though about 50% of US banking system assets were invested in US Treasuries, US banks' holdings of Treasuries securities were actually *not* a source of financial instability. So why not follow this approach today and encourage increased US banks' holdings of Treasuries securities? Simply put, we are no longer in the financial system of the 1950s.

For instance, in the 1950s, Federal Reserve Regulation Q prohibited US banks from paying interest on checking accounts/demand deposits. In 1950, these deposits were about 75 percent of US banks' total liabilities. That meant that 75 percent of US bank funding had zero interest cost. Ceilings also existed on the interest that US banks could pay on other deposit accounts. US banks were heavily invested in Treasuries and bank failures were negligible. In essence, Regulation Q permitted the US government to use banks to cheaply and safely fund the US government at negative real interest rates — the essence of financial repression. Given interest rate deregulation in the 1980s due to the growth of the US money market fund industry, today it is impossible to safely use US banks to fund the US government in such a manner again because banks need to compete for deposits. It also should be recognized that using banks to fund the Treasury market implies significantly less lending to US small businesses which are a key engine of US economic growth.

If anything, high bank exposure to Treasuries, combined with the absence of quantitative regulation of interest rate risk and weak supervision of interest rate risk, means that a sharp rise in Treasury yields can indeed pose a threat to US banks, as Silicon Valley Bank's failure in 2023 revealed. Indeed, there have been no US regulatory changes post-SVB with regards to interest rate risk. Rather, the contradiction of regional US banks receiving regulatory relief through 2018 bank regulatory "tailoring," but requiring systemic risk exceptions (SVB, First Republic) when they failed in 2023 continues.

It is plausible that some policymakers may have drawn the conclusion from the US bank failures in 2023 and in the elections that followed in 2024 that voters no longer care about banks. The 2024 election was a notable contrast to the 2008 election, when developments related to the unfolding Global Financial Crisis and US banks were influential in US electoral politics. A key difference in 2023 was the absence of a US banking-induced recession impacting both Main Street livelihoods and voters' 401k account values. Lingering Covid fiscal stimulus and continued expansionary fiscal policy helped contain the damage in parts of the US banking sector from spreading to the US economy more broadly. So will voters continue to disregard US bank regulatory policies going forward? The resounding answer to this question is "no." History teaches us that banking-led economic downturns tend to be associated with both deeper and longer recessions and that this matters to voters. If further financial deregulatory and

supervisory mistakes are made in a more adverse macroeconomic environment like stagflation, a more severe US financial sector led downturn could ensue.

Turning to my second point, the Federal Reserve's use of unconventional monetary policy has both contributed to unsound fiscal policy and been destabilizing to the US banking sector. The Federal Reserve, the Administration and Congress should recognize that the overuse of unconventional monetary policy has unintentionally contributed to a worsening of the nation's finances. In this regard, I do not support excluding banks' reserve balances held at the Federal Reserve from banks' leverage ratios as this would effectively uncap unconventional monetary policy and allow for even larger Federal Reserve balance sheet expansions in the future.

Unconventional monetary policy, otherwise known as quantitative easing or QE, is destabilizing to the Treasury market and banks in several important ways:

QE reduces the term premia on long-dated US Treasuries, so implicitly it has encouraged excessive government budget deficits. QE changes the maturity profile of the consolidated US public sector's liabilities – meaning that the Fed's short-term liabilities are used to fund the Fed's long-dated asset purchases, exposing the consolidated public sector to losses which now exceed $200 billion on the Fed's balance sheet. Shortening the maturity profile of the consolidated US public sector's debt stock implies that US public debt service metrics can worsen rapidly.

QE enables successively larger crisis interventions that can worsen the public sector balance sheet and also contribute to higher income inequality.

In practice, unconventional monetary policy has been destabilizing for US banks. Specifically, QE creates both reserve balances (a bank asset) and uninsured deposits (a bank liability) in the US banking sector. In the absence of strong US banking practices around interest rate risk, when interest rates are low during QE, some banks may over-invest these new deposits in fixed rate assets. Additionally, some banks will get rid of term funding when interest rates are low because they are "flush" with deposits – not recognizing that QE-related deposits could unwind quickly if the Fed needs to tighten. When QE is reversed through quantitative tightening, or QT, it is generally accompanied by higher interest rates so a bank's fixed rate assets could be devalued at the same time shrinkage in the Fed's balance sheet withdraws QE-related banking sector deposits.

Turning to my final point, we urgently need to run a more responsible fiscal policy. Bank deregulation and/or unconventional monetary policy are the wrong tools. When I was a financial economist in US Treasury debt management prior to the 2008 financial crisis, US government debt to GDP was about 60%. Fast forward to today and US government debt to GDP has swelled to ~100% – debt levels last seen around World War II. Over the intervening period, Democrats have passed laws permitting more spending; Republicans have passed laws granting lower taxes. Irrespective of who is controlling the White House and Congress, we have ended up with ever larger budget deficits and more US government debt. Indeed, running a budget deficit of 7% of GDP as we are doing today outside of a recession would have previously been unheard of.

As we know, the US government borrows in its own domestic currency. Therefore, in a real sense the government prints the money needed to fund its own deficit. What can go wrong? At least, three problems can emerge.

First, at higher and higher levels of US government debt to GDP, financial frictions begin to emerge in money creation getting recycled back to fund the US Treasury market. Specifically, the problem emerges when the growth in the US government debt stock is so rapid that it exceeds growth in the balance sheets of investors with both stable funding and willingness to hold Treasury securities. We are seeing foreign central banks and large asset managers intermediate smaller shares of the Treasury market. By contrast, hedge funds have become a larger and larger share of Treasury market intermediation, including via the basis trade which results from asset managers taking exposure to Treasury futures.[2] Recent developments with regards to tariffs may reduce foreign investor appetite – both foreign central banks and foreign private investors – for US Treasuries and other US financial assets. So reduced demand for US assets from foreign investors with stable balance sheets means more mark-to-market sensitive investors own Treasuries which, in turn, increases the sensitivity of the US Treasury market to shocks and the overall volatility of the Treasury market.

Second, higher volatility drives up US government financing costs and, over time, can be expected to crowd out corporate and household borrowers and to slow economic growth. The 10-year US Treasury term premium as estimated by Adrian, Crump and Moench's model had been falling for several decades, but inflected during Covid as US labor force growth slowed and now the term premium has begun to rise. The upward shift in the trend of the 10-year Treasury term premium is worrying given elevated US government debt levels. A danger is that it is underestimated how "low" US Treasury yields are right now – given that inflation still remains elevated and more volatile, US budget deficits are higher and the stock of Treasury debt to be financed so much larger. It is worth remembering where Treasury yields were through the 1990s as a risk scenario for US banks which continue to have as of Q1 2025 ~$500 billion in unrealized securities losses at prevailing yield levels. A prolonged bear steepening move in the US Treasury market is a plausible risk scenario and one that would already negatively impact many US banks in light of their current securities and fixed rate loan exposures. In sum, encouraging US banks to hold more Treasury securities through bank deregulation may increase banking sector risks.

Third, history suggests that high government debt stocks are often solved through elevated inflation, eroding a currency's international purchasing power, but diminishing its debt stock in real terms. In their 2018 paper on modern banking crises, International Monetary Fund (IMF) staff define a currency crisis as meeting two conditions: a depreciation of at least 30% y/y; and a depreciation at least 10 percentage points higher than the prior year.[3] Based on Fund staff's definition, movements in gold against the US dollar that began under the Biden Administration and have continued under the Trump Administration suggest the US dollar is not far from being in a currency crisis relative to gold. Foreign central bank reserve diversification into gold has been notable. Since 2011, seven US states also have passed legislation accepting gold and silver as legal tender. Indeed, Treasury market fragility and the erosion of the US dollar's status are interlinked.

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[2] Barth, Kohn, Monin and Sokolinskiy ("Reaching for Duration and Leverage in the Treasury Market," Federal Reserve discussion paper, June 2024) show that when other fixed income securities (agency MBS, CLOs) become more attractive relative to Treasuries, asset managers sell Treasuries and buy the more attractive US fixed income assets which introduces tracking error — a widening gap between portfolio duration and the portfolio's benchmark duration. Asset managers establish long positions in Treasury futures to reduce this duration gap which, in turn, gives rise to the basis trade involving both asset managers and hedge funds.

[3] "Systemic Banking Crises Revisited," IMF staff working paper, Laeven and Valencia, 2018.

Delayed adjustment is always a more painful adjustment. The Trump Administration is seeking to raise revenue through tariffs and also narrow the US budget deficit through cuts to discretionary spending. According to a forecast released this week from Bloomberg Economics, US government debt is projected to reach 126% of GDP in 2034, down from a previous forecast of 132% thanks to forecast tariff revenue and discretionary spending cuts. While this is welcome progress, 126% government debt to GDP still would mark a significant increase from ~100% in 2024 and reflects Bloomberg's current estimates of planned tax cuts in H2 2025.

Winston Churchill once observed that "Americans can always be trusted to do the right thing, once all other possibilities have been exhausted." The combination of fifteen years of near zero interest rates, Social Security receipts funding other US borrowing, and elevated Federal Reserve remittances totaling roughly $1 trillion to the Treasury from 2011-2022 due to QE together made the rise in US public sector indebtedness feel costless – until it wasn't. Significant structural economic changes such as deglobalization, aging demographics, and reduced immigration imply higher inflation and structurally higher interest rates ahead and require different policies. In light of these trends, it is imperative that Congress undertake a review of all of US non-discretionary spending, discretionary spending, and tax expenditures that disproportionately benefit high income Americans.

Since the Great Depression, the US and other advanced economies have moved from the gold standard to fiat money. Fiat money enabled more credit growth, financial wealth became more widespread, and use of leverage was democratized. The resulting surge in financialization of the US economy created public demand for ever bigger and more costly government and central bank ex-post financial crisis interventions, but also public, industry and even government resistance to ex-ante regulatory guardrails that might slow credit provision. These multi-decade dynamics have left us with significant fiscal, monetary and financial sector challenges. Additionally, this highly financialized system has disproportionately benefited some – mostly older generations of Americans who own more financial assets – relative to others – mostly younger generations who generally own fewer financial assets. The Administration aims to strengthen US national security through reindustrialization of national security relevant industries and reducing the high US government debt stock. I support these important objectives. But how will the burden of these economic adjustments be shared?

My key message is this – those who benefited more from our highly financialized system now need to make fiscal policy sacrifices for younger Americans to have opportunities, for the US to stabilize its demographics, and for our society to remain strong and successful. If younger Americans cannot afford to start families, US demographics cannot be stabilized. More dialogue is needed about how to create opportunities for younger Americans. Through this lens of fiscal policy needing to consider generational rebalancing, the draft House tax legislation that would increase the SALT deduction to $30,000 and not increase taxes on those making more than $2.5 million is disappointing and I hope will be reconsidered.

In closing, what can be done with regards to promoting US Treasury market stability?

In light of deglobalization, aging demographics, and reduced immigration, it is time to stop using inappropriate tools like bank SLR/G-SIB surcharge deregulation or unconventional monetary policy that attempt to "stabilize the Treasury market," but do nothing to address the important issue of sound fiscal policy. It is time to recognize both that greater fiscal discipline is urgently needed and that it is essential that US fiscal policy be structured with an eye to making life more affordable for younger Americans so that US demographics, labor force growth, and, indeed, our country's future can be stabilized.

HFSC: Reflections on bank SLR/liquidity debate – or how I recovered from being a skeptic…

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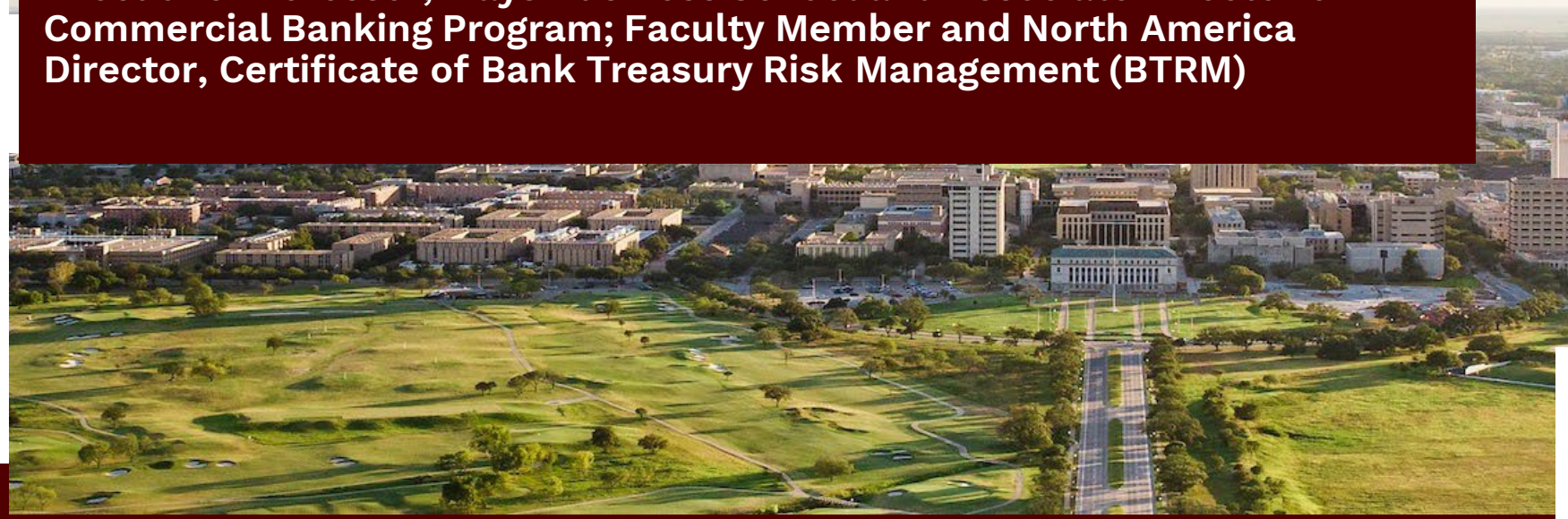

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SLR and LCR – I started off a bit of skeptic

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Do higher capital standards always reduce bank risk? The impact of the Basel leverage ratio on the U.S. triparty repo market ☆

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The Difficult Business of Measuring Banks' Liquidity: Understanding the Liquidity Coverage Ratio

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Capital centric view (policy consensus) vs ALM integrated view (reality)

- High levels of risk-based capital solve all problems.
- Bank runs happen when asset values are uncertain and therefore depositors perceive solvency is at risk.
- Main concern is adequate quantity and quality of risk-based capital.
- If the bank is adequately capitalized, liquidity problems can be solved through central bank lending and are of limited relevance.

- Liquidity is the ability to ensure the availability of funds to meet a bank's contractual and contingent commitments at a reasonable price at all times.
- 1) Liquidity, 2) interest rate risk and 3) profitability are inextricably interlinked and cannot be thought about separately.
- Profitability is a bank's first buffer against loss and, along with CECL and capital, part of the three legs of the stool of a bank's loss absorbency.
- A bank can be "well capitalized", but NPV negative/weak economic capital.

Fed liquidity does not work in all macroeconomic environments; it works poorly when supply shocks/interest rate shocks occur

Implications of excess pursuit of net interest income (NII) on subsequent profitability, economic capital, liquidity and asset growth	
	Yield curve positively sloped followed by elevated inflation
Excessive short-term focus on NII leads to …	**Significant borrow short/lend long fixed rate**
Initial impact on profitability but big EVE risk	**Positive –** because short-run NII boost from long-dated fixed rate assets
Economic capital impact after shock	**Negative** if rates rise.
Liquidity impact	**Negative** if rates rise.
Asset growth/repricing	**Negative** – weak asset growth and slow repricing if rates rise.
Central bank lending as stabilizer	**Negative** – absence of rate cuts so central bank funding costly vs deposits.

- Concomitant QT with interest rates still high
  - Reduces central bank reserves/bank liquidity
  - Pressures bank deposits as government securities that runoff central bank balance sheet are refinanced by non-bank financial institutions – drawing down bank deposits.

Central bank liquidity injections are costly

- In 2008 Fed liquidity injections into US banks contributed to the launch of unconventional monetary policy.
- Unconventional monetary policy is destabilizing in three ways.
  - In practice, QE creates both reserve balances and uninsured deposits in the banking sector.
  - QE reduces term premia so implicitly limits bond market discipline on government budget deficits.
  - QE enables successively larger crisis interventions that ultimately worsen the public sector balance sheet.
- First Republic was economically insolvent. Fed lending to First Republic enabled deposit flight and transferred losses from Fed to FDIC and ultimately other US banks through DIF assessment.
- Proposals for required liquidity related to uninsured deposits have receded. LCR recognizes that liquidity risk is broader than uninsured deposits.

IRB-BB and LCR would have helped/supervision is not enough

- Feldberg, Cetina, Mott (2025)
  - IRB-BB outlier test would have identified SVB as a risk 10 quarters prior to failure.
  - LCR would have flagged SVB four quarters prior to failure.
  - Regulatory tailoring contributed to 2023 bank failures, but no regulatory changes post SVB.

- IMF staff pointed out in its last two US financial sector assessments (2015 and 2020) that the US banking system lacked adequate quantitative regulation of IRR-BB.

- "Tracing Bank Runs in Real Time" (2024) makes use of data uniquely available to Fed staff -- 22 US banks had runs following SVB's failure.
  - But uses asset size as control as opposed to relevant US bank regulatory cutoffs (Cat I-IV banks) for the LCR and inclusion of AOCI/unrealized available-for-sale securities gains/losses in reg capital.

Table II. Partial Correlation Matrix CAMELS and CAMELS Component Ratings

	CAMELS	Cap	AQ	Man	Earn	Liq	Sens
CAMELS	1.00						
Cap	0.27	1.00					
AQ	0.32	0.18	1.00				
Man	0.65	-0.07	0.07	1.00			
Earn	0.24	0.18	-0.01	0.04	1.00		
Liq	0.09	0.24	0.07	0.02	0.02	1.00	
Sens	0.11	0.01	-0.05	0.08	0.12	0.16	1.00

- Gaul and Jones (2021) – 1984-2020 S sub-component is weakly correlated with others, suggesting S rating may capture new information.

- Can approximate the r2 of each CAMELS component to the overall composite CAMELS rating. For the S rating, this calculation implies that only ~1% of the variation in a bank's CAMELS composite rating is attributable to the variation in a bank's S rating. This is the second lowest individual CAMELS sub-component contribution with L being the lowest.

- Gopalan and Granja (2024) have access to more current US bank supervisory exam data (Q4 2021 to Q1 2023). Their work shows no relation between the frequency of downgrade of a bank's "S" or "L" rating and examined banks' interest rate exposures prior to Q2 2022 - when the Federal Reserve began to raise interest rates.

Remove Treasuries from SLR – no, we are not in 1950

- Proposals to remove Treasuries from SLR, "tweak" G-SIB surcharge.
- In 1948-1950 US banks financed large quantities of US government securities when debt/GDP was elevated – we are not in 1950s.
- Reg Q restrictions capping deposit rates mostly eliminated.
- Risk creating bank/sovereign nexus.
- Start of classic government crowding out private sector?

Table 19. Assets and Liabilities of All Banks in the United States and Possessions, December, 1950, 1949, and 1945

Asset, liability, or capital account item	Amount (in millions)			Percentage distribution		
	Dec. 30, 1950	Dec. 31, 1949	Dec. 31, 1945	Dec. 30, 1950	Dec. 31, 1949	Dec. 31, 1945
Total assets	**$192,241**	**$180,043**	**$178,203**	**100.0%**	**100.0%**	**100.0%**
Cash and funds due from banks	41,236	36,676	35,585	21.4	20.4	20.0
United States Government obligations	73,188	78,754	101,822	38.1	43.7	57.1
Obligations of States and subdivisions	8,249	6,657	4,064	4.3	3.7	2.3
Other securities	6,568	6,025	4,531	3.4	3.3	2.5
Loans and discounts—net	60,711	49,828	30,473	31.6	27.7	17.1
Miscellaneous assets	2,289	2,103	1,728	1.2	1.2	1.0
Total liabilities and capital accounts	**$192,241**	**$180,043**	**$178,203**	**100.0%**	**100.0%**	**100.0%**
Total deposits	176,120	165,244	166,474	91.6	91.8	93.4
Miscellaneous liabilities	2,205	1,633	1,203	1.2	.9	.7
Total capital accounts	13,916	13,166	10,526	7.2	7.3	5.9
Number of banks[1]	14,693	14,736	14,725	.....	.....	.....

[1] Asset and liability data were not available for 27 banks on December 30, 1950, 31 banks on December 31, 1949, and 104 banks on December 31, 1945.

Detailed data for 1950: See Table 105, pp 232-33.

Stagflation coming – bad for banks, but response…

- Stagflation is most stressful macroeconomic scenario for banks – it stresses capital, liquidity and interest rate risk simultaneously.

- But many US banks are returning capital (share buybacks), bank deregulation on the table and no effort to improve liquidity or quantify interest rate risk.

- Are US banks better prepared for stress of stagflation? Unlikely

- Banks need to stress test to stagflation and 6% 10-year Treasury yield.