William C Dudley: The evolving structure of the US treasury market

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at The Evolving Structure of the U.S. Treasury Market: Third Annual Conference, Federal Reserve Bank of New York, New York City, 28 November 2017.

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On behalf of the Federal Reserve Bank of New York and our co-sponsors—the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System, the U.S. Securities and Exchange Commission, and the U.S. Commodity Futures Trading Commission—I would like to welcome you to this year's conference on the structure of the U.S. Treasury market. As always, what I have to say today reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.

This is the third year the New York Fed has co-hosted the Treasury market structure conference, which provides an opportunity to deepen our understanding of the changing landscape of the Treasury market. Many of you remember the market volatility of October 15, 2014, that precipitated the need for additional engagement between the private and public sectors about Treasury market structure. The Joint Staff Report on the Treasury flash event, the Treasury Department's subsequent request for information, and the work that has followed identified a number of changes that have reshaped the Treasury market over the last decade. These include the increased electronification of trading, the changing nature of intermediation and liquidity, and the entry of new market participants. In light of these changes, the Joint Staff Report highlighted four important priority areas for additional work. In taking these efforts forward, we have benefited from ongoing engagement with market participants and other members of the public.

The first priority is gatherings like this one, where both private and official sector participants come together to study and share views on what the market's evolution means for its structure and liquidity. Understanding how the Treasury market is evolving can enable us to be good stewards of its trajectory.

A second priority is improving the availability of data on activities in the cash market. After the historic volatility that occurred on October 15, 2014, the official sector had limited access to transaction data. This resulted in a months-long lag in the process to gather and analyze data from the event. The introduction this year of transaction data reporting by broker-dealers to the official sector is thus a critical step forward. While closing this data gap for the official sector is an important milestone, work remains to ensure that the scope of collection is sufficiently complete and dynamic to maintain coverage of relevant firms, as intermediaries and liquidity providers evolve. One initiative in this direction is the Board of Governors' plan to collect transaction data from depository institutions.

Looking ahead, I expect that a continuing priority will be increasing data transparency to all market participants and to the public in a manner that supports—and does not harm—market liquidity and integrity. Part of the successful evolution of the modern Treasury market will be adapting to the data needs of its participants. I believe transaction data reporting to the public based on careful study will ensure that the Treasury market does not fall behind other markets, will promote a robust and level playing field, and will help safeguard the liquidity characteristics that make the Treasury market the benchmark for risk-free trading around the world.

The rise of electronic trading, another market feature highlighted in the Joint Staff Report, helped to identify a third priority area: the market practices and risks associated with the Treasury market. Market infrastructure—including the financing of Treasury transactions, as well as the clearing and settlement of those transactions—seldom merits investor attention until an element that is vital to smooth functioning of the market goes awry. The history of financial markets is filled with examples—some recent—in which confidence in trading collapsed after market participants no longer knew or could assess the underlying risk of market engagement, leading them to disengage. While such disengagement may be rational from the perspective of an individual participant, it is destructive to the collective market function.

A major infrastructure issue for the Treasury market has been the clearing and settlement practices of the cash market. This can be opaque, with a majority of trades cleared away from central counterparties (CCPs). While central clearing is more uniformly used in other segments of the Treasury market—such as futures—many market participants elect to clear and settle cash Treasury transactions in a bilateral fashion. This process includes many market participants: trading venues, clearing agents, and clearing banks. No single participant has a view of the entire clearing and settlement system.

The Treasury Market Practices Group (TMPG), a New York Fed-sponsored group of market professionals working to support the integrity and efficiency of the Treasury market, has concentrated its recent efforts on this topic. Preliminary findings include an increasing volume of linked trades that clear centrally on one side and bilaterally on the other. This work has also uncovered information asymmetries in clearance and settlement risk management, which potentially could lead to a mispricing of these risks. Moreover, increased understanding about the depth, breadth, and durability of credit arrangements that support clearance and settlement seems desirable. This would improve market integrity through greater understanding of risk throughout the clearing and settlement process and how it is affected by different conditions.

Since the financial crisis, there has been an effort to strengthen the resiliency of repo market infrastructure, which is another important element of Treasury market plumbing. Immediately after the crisis, the Federal Reserve was active in pushing reform of the tri-party repo market, which had been a locus of stress in 2008. More recently, Treasury repo markets have undergone further changes, including market adaptations to post-financial crisis regulations, and the introduction of multiple programs expanding access to central clearing to a wider range of market participants. These markets also have been affected by efforts to set heightened expectations for CCPs with regard to liquidity risk management, margins, and governance and recovery planning. This is consistent with the Treasury Department’s recommendation that regulators ensure appropriate risk management at CCPs and other financial market infrastructures. For example, earlier this month, the SEC approved the Capped Contingency Liquidity Facility—a liquidity risk management tool for the DTCC’s Fixed Income Clearing Corporation (FICC). This tool helps to ensure that FICC will have sufficient liquidity to cover the default of a Government Securities Division member to which FICC has the largest exposure. This development reflects another positive step toward a safer centrally cleared repo market, and aligns well with broader official sector efforts to maintain a well-functioning and robust Treasury repo market.

Finally, the Joint Staff Report identified the importance of strong interagency monitoring of the Treasury market, in close collaboration with the public. Judging by this gathering, the commitment to this task is strong—which is good because many questions remain. How can the Joint Member Staffs and private stakeholders best collaborate to ensure stability in the Treasury market as the market structure evolves and new technologies are applied? How should practices and culture evolve accordingly? Will new technology and automation in the marketplace introduce unexpected challenges or risks to Treasury market participants? Are there opportunities to improve market transparency in a way that sheds light on risk issues that emerge as the market continues to evolve? Are the regulatory requirements imposed upon the Treasury market appropriate in the current environment? Has a competitive level playing field been maintained given the evolving structure? And, are there any changes that could improve the functioning, efficiency and/or integrity of the Treasury market?

As I highlighted before, answering such questions well could require greater transparency. It is important for officials and market participants to fully understand the range of market elements. These include the relative size of transaction volumes by various players, the breadth and resiliency of platforms used to facilitate risk transfer, and the robustness of market infrastructure under contingent circumstances. More broadly, interagency efforts and collaboration with the public to shed light on the evolving structure and its risks are critical to protecting Treasury market function and supporting investor confidence. Because we benefit from the Treasury market being the deepest and most liquid market for government securities, complacency should not be an option. We need to work together to ensure that the longstanding confidence in the Treasury market is sustained in the future.

This conference provides an excellent opportunity to continue this discussion and work on these issues. Thank you for coming. I look forward to today's dialogue and the ongoing engagement between the Joint Member Staffs and the public.