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# Still the World's Safe Haven?

## Redesigning the U.S. Treasury Market After the COVID-19 Crisis

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### About the Policy Brief

*This policy brief is a summary of a working paper presented at the Hutchins Center on Fiscal & Monetary Policy on May 27, 2020. The paper is available here, and video and transcript of the presentation and discussion are here.*

### Problem

The onset of the COVID-19 crisis in March proved surprisingly disruptive to the economically and financially critical market for U.S. Treasury debt. This was a wake-up call. It exposed significant weakness in market infrastructure, which is particularly concerning given the Treasury's need to raise huge sums in the bond market to finance growing budget deficits.

### Solution

The federal government should initiate a comprehensive and rigorous cost-benefit analysis of clearing secondary market trading in U.S. Treasury debt at a central counterparty, a clearinghouse, similar to those used to clear trades in derivatives and equities. Central clearing would improve financial stability, increase market transparency, and reduce the current heavy reliance of the market on the limited space available on dealer balance sheets for intermediating trade flows.

## What exactly happened?

The market for U.S. Treasuries has long been viewed as the world's deepest and most liquid financial market. That presumption was questioned in March 2020, when the COVID-19 crisis triggered heavy demands from investors—including hedge funds and other institution investors, as well as foreign central banks and sovereign wealth funds—to sell Treasuries, overwhelming the capacity of the affiliates of big banks (known as "dealers") that usually buy and sell Treasuries as middlemen ("intermediaries") without difficulty. In mid-March, almost every measure

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of market function signaled distress: The yield on Treasuries (which moves the opposite direction to price), actually rose; usually the yield falls on bad economic news. The spread between the price traders offered to buy Treasuries (“bid”) and the price they offered to sell Treasuries (“ask”) increased more than tenfold. Yields on similar-maturity Treasuries, which usually are very close together, moved apart. The number of trades that were not successfully completed (“fails”) rose.

In response, the Federal Reserve purchased $1 trillion of Treasuries over the three-week period from March 16, and continued to buy heavily after that. By mid-April, this and other emergency moves by the Fed had significantly calmed the market. Despite the Fed’s success, the COVID-19 crisis tested the extent to which the secondary market for Treasuries can safely and efficiently handle surges in investor trading demands that can be expected, episodically, in coming years. Although the Fed accomplished what it needed to do, it is unacceptable that the structure of a private market like the secondary market for U.S. Treasury debt should rest on the hope that the Fed will rescue it as a last resort if need be.

## Why did this happen?

In short, the Treasury market appears to have outgrown the capacity of dealers to safely serve as middlemen between buyers and seller—to intermediate the market—raising concerns about maintaining the status of U.S. Treasury debt as the world’s safest asset and the cost to taxpayers of financing growing federal deficits. In 2020 alone, the stock of marketable U.S. Treasuries is projected to increase by about $3.8 trillion, or 23 percent, to $20.5 trillion.

Regulatory reforms triggered by the financial crisis of 2008-2009 have limited the appetite of dealers affiliated with big banks to hold large quantities of Treasuries on their balance sheets, even for short periods of time. New capital requirements and other regulations force bank shareholders to bear more of the costs of financing market-making inventories. These rule changes have improved financial stability and reduced investor expectations that taxpayers will bail out banks if they get in trouble. But they also are a reason that large banks’ balance sheets have not kept up with the growing stock of marketable Treasuries. The cost to taxpayers of financing federal deficits depends on the efficiency of the secondary market for Treasuries. To intermediate a growing volume of U.S. Treasury trades, banks would need to substantially increase their capital commitments to the business; that would hurt shareholder returns unless dealers raise the effective price they charge for acting as middlemen. This eventually could boost the interest rate that the Treasury—that is, the taxpayers—pays to borrow.

## What’s the solution?

In any financial market, after a transaction between two parties is executed, the trade is “cleared” in a sequence of steps that prepares the trade for settlement, the final exchange of cash for securities. Central clearing involves the additional step of guaranteeing trade settlement. Once a trade is centrally cleared, the original buyer and seller are no longer exposed to each other for settlement risk—they instead face the central counterparty (CCP), also known as a “clearinghouse.” In case of a default, the surviving clearing members of the CCP are mutually responsible for providing the liquidity needed to resolve the failure, and to cover ultimate losses.

In the market for U.S. Treasuries, most trades are between two parties. They are not centrally cleared. A participant in the market for Treasuries faces a CCP in only 22.4 percent of Treasury transactions. By comparison, central clearing covers virtually 100 percent of exchange-traded derivatives and equities, and the majority of swap-market transactions.

Central clearing of Treasury transactions would significantly reduce the need to warehouse trade flows on dealer balance sheets. Dealers would be better able to net their buy and sell trades with central counterparties. Given broad access to a CCP, some Treasury transactions could flow directly from ultimate sellers to ultimate buyers without impinging on dealer balance sheet space. The transparency of the trade settlement process would improve, and counterparty settlement risk would decline, improving financial stability. A broad Treasury market clearinghouse could be based on an expansion of the role of an existing clearinghouse or a new stand-alone facility operated as a private-sector utility or by a government agency.

The infrastructure associated with this market reform would likely be expensive. Nevertheless, the evident dysfunction of the market in March and the likelihood that such episodes will recur given the rapidly growing supply of U.S. Treasuries suggest that the expense is justified. The regulators of the U.S. Treasury market should consider a study of the costs and benefits of introducing a broad central clearing mandate.

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*The author is a member of the board of Dimensional Funds, representing the interests of shareholders of mutual funds, some of which invest in Treasury securities, and has also recently been compensated for an expert report in litigation covering issues that include central clearing and all-to-all trade in the market for swaps.*

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