Remarks by Craig Phillips, Counselor to the Secretary, on Market Structure

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Introduction

Good morning. Let me begin by thanking the Federal Reserve Bank of New York for co-hosting this important conference on the evolving structure of the U.S. Treasury Market. This conference is a critical forum for communication among the official sector and private sector Treasury market participants, which is a necessary ingredient for well-informed policy decision making. This morning I will provide an update on Treasury's initial analysis of the TRACE data. I will also review a few other important work streams at Treasury, including Treasury's recent report outlining ways to streamline and reduce burdens of capital market regulation.

It is an honor to represent the U.S. Treasury every day – but that is particularly true today given this opportunity to address such an important group of stakeholders of the Treasury securities market. I know Secretary Mnuchin feels the same way and greatly appreciates the opportunity to address you this afternoon. I also want to acknowledge and thank my colleagues from the Treasury engaged in the critical function of debt management – many of whom are here today – without their contribution our markets could not function as smoothly as they do.

The Treasury staff is dedicated to strong market functioning to ensure that the Treasury market remains the deepest and most liquid market in the world. Fostering an efficient and liquid Treasury market helps us to minimize debt service costs. This lowers benchmark rates for other instruments, like corporates, agencies, and mortgages, providing cost benefits to all borrowers. In addition, a robust and liquid Treasury market reduces frictions and provides significant benefits for market participants that use Treasury securities for hedging or as collateral.

However, the structure of the U.S. Treasury market has evolved in recent years with the increased use of electronic trading and the shifting roles of market intermediaries and end investors. This evolution was most apparent on October 15, 2014, when the market for U.S.

Treasury securities experienced a very high level of volatility and a rapid round-trip in prices. Such significant volatility within minutes with no obvious catalyst called for a deeper analysis of the conditions that contributed to the volatility and of the market structure in general. In response to this, staff at Treasury, the Federal Reserve Board (Board), the Federal Reserve Bank of New York (FRBNY), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) issued a report analyzing the events of the day, the Joint Staff Report.

The JSR highlighted the ways in which advancements in technology and growth in high-speed electronic trading are changing the structure of the Treasury market. To learn more about these changes, Treasury issued a *Request for Information on the Evolution of the Treasury Market Structure* last year. This sought public comment on the need for more comprehensive official sector access to Treasury market data. Nearly all commenters who addressed official sector collection of Treasury cash market data agreed that the official sector should have access to more information about cash market activity. Many commenters broadly encouraged Treasury to leverage existing infrastructure to collect Treasury market trade data to minimize the compliance burden associated with trade reporting. The Financial Industry Regulatory Authority's (FINRA) Trade Reporting and Compliance Engine (TRACE) was cited most often as the preferred tool for doing so. In October of last year, the SEC issued an order approving FINRA's amendment to its rules for TRACE to require its members to report certain transactions in Treasury securities starting July 10, 2017.

The post-trade data on Treasury security transactions collected in TRACE provides the official sector with comprehensive data. Today I am going to share some initial findings from Treasury's analysis of the data that we have been receiving since July. It is important to note that Treasury has just begun to analyze the new data and although we are in the early stages, I will relay a few initial observations that we have found most interesting from a market structure perspective.

<u>Presentation of the Data</u>

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Our first graphic provides a stylized depiction of Treasury market trading. As can be seen in this diagram, dealers facilitate trades with customers and affiliates either directly or through request for quote (RFQ) platforms. Dealers trade directly with each other. They also trade on interdealer broker (IDB) platforms with other dealers as well as principle trading firms (PTF). The TRACE data allows us to size the market among its various participants and trading venues such as IDB, dealer-to-dealer (DtD), and dealer-to-customer (DtC) or affiliate markets. Understanding the changing architecture of the market structure and flows between these parties is integral to developing the best policies for the Treasury market and ultimately the most appropriate and effective use of the TRACE data.

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In this figure the daily trading volumes by venue are presented. According to our analysis of the data, the more than $500 billion average daily Treasury market volume is roughly split between trades that occur on IDB platforms and those that do not. These other venues include DtC or DtA markets, with a small remainder in the DtD channel. While there has been a growing presence of non-dealers in IDB platforms, particularly PTFs, the dealer-dominated trading volume occurring outside of IDB platforms is still about half of the total market represented in the TRACE data. Therefore, despite the many changes in technology and regulation that may have impacted the Treasury market in recent years, it is safe to say that dealers are still at its center and continue to play a critical role in its smooth functioning.

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Let's now look at daily volume by security type. When looking at trading among certain securities, most of the aggregate volume is in nominal Treasury coupons, with lower but not insignificant volumes in Treasury bills, Treasury Inflation Protected Securities (TIPS), Floating Rate Notes (FRNs), and Treasury Separate Trade of Registered Interest and Principal of Securities (STRIPS). Since coupons represent the largest category in terms of trading volumes and amount outstanding, we can use the data to dig down further into trading activity among different tenors and on-the-run versus off-the-run status.

Slide 5

Cutting the data by maturity bucket presents another view of activity. We see that the average daily volume among coupon securities is divided roughly evenly between the buckets of 0 to 2 ½ years, 2 ½ to 5 ½ years, and 5 ½ to 10 ½ years, with smaller volumes for 10 ½ to 30 years in maturity. The longer-dated bucket still trades on average over $30 billion per day, while the shorter-dated buckets each trade over $100 billion per day on average.

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A significant question answered by the initial review of the TRACE data is the relative volume of on-the-run and off-the-run securities trades by venue. Treasury's analysis finds that although on-the-run Treasury securities account for a majority of transactions, off-the-run Treasury securities still trade in significant volumes. Off-the-run trades account for almost one third of total nominal coupon trades. Even with the growth in electronic trading in recent years, it appears that most of this off-the-run activity is intermediated by dealers. This further underscores the critical role that dealers play in promoting liquidity in the Treasury market.

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Taking a deeper dive in the off-the-run market trading segment, we can see from this chart that there is significant volume in seasoned securities. Volume is divided about 1/3 to 2/3 in between the 1st off-the-run and the 2nd and older off-the-run – that is, deeper off-the-run securities.

Now, as a reminder, the data analysis shown today is preliminary. We see the first stage of our analysis of the TRACE data as cleaning and verifying the market sizing, primarily by matching trades across reporting types. The next stage of the analysis will be more focused on liquidity metrics and pricing, including price impact and dispersion across trading venues and market participants.

While our initial analysis has yielded valuable insight, it has also uncovered areas that need to be improved to make the data more useful. For example, the granularity and accuracy of the timestamps on trades reported to TRACE may need to be modified. Likewise, as Treasury's recent report on capital markets in response to the *President's Executive Order on the Core Principles for Financial Market Regulation* has noted, gaps in the Treasury securities transaction data available to the official sector still exist. In particular, PTFs and investment fund trading activity is not easily identified in the TRACE data because they are generally not FINRA broker-dealer members. For banks that conduct a government securities business but are not broker-dealers and FINRA members, trading activity in Treasury securities is also not reported to TRACE. We are now exploring the means to close these gaps with our colleagues at the Board and the SEC. Recently the Board has indicated that it is continuing to work through the details of collecting Treasury transaction data from certain depository institutions.

Another topic that often arises when discussing the TRACE data is public dissemination. At this initial stage the trade-level data on Treasury securities transactions are only available to the official sector. The policy concerning public dissemination of the data is actively being considered. While support for official sector data collection was nearly unanimous in the RFI comment letters last year, support for public dissemination of Treasury market trading data was far more mixed. Multiple commenters, including the Securities Industry Financial Markets Association (SIFMA) and several dealers and buy side firms, argued that public post-trade reporting would impair liquidity in the Treasury market, especially for less frequently traded securities. Nonetheless, we understand the importance of transparency and the potential value of making certain data broadly available for public use.

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Looking at the historical evolution of collection and public dissemination of TRACE data for other key markets is a useful benchmark. In the case of corporate bonds, a phased in approach spanned four years from 2002 to 2006. There were multiple phases with multiple components to each phase, in which the reporting time was slowly decreased from 75 to 15 minutes and the eligible assets were slowly broadened to less liquid bonds. Public dissemination was also phased in based on the size and ratings of corporate bonds, with 2 and 4 day dissemination delays at first for less liquid bonds. After four years of phased implementation, dissemination delays were eliminated in January 2006. However, caps on trade sizes disseminated remain to this day, capped at $5 million for investment grade corporates and $1 million for high yield.

We are carefully analyzing the issues before considering how to proceed with any policy proposals regarding the appropriate level and form of data about Treasury market activity that may be made available to the public. In order to inform such a policy proposal, Treasury is taking a data-driven approach. We do not anticipate making any announcements until the official sector has had time to conduct a thorough analysis.

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Let's focus for a moment on the high level principles that outline key considerations to guide our thinking in developing a policy on the public dissemination of the TRACE data:

First, recognizing that the Treasury market is the deepest and most liquid market in the world and that it is critical for funding the Federal Government, our paramount concern is to "do no harm" to the market.

Second, in deciding whether to disseminate data, it should be clear that Treasury's primary objective is to fund the U.S. Government at least cost to the taxpayer over time. The data must be used in ways that are consistent with this objective, and that enhance liquidity in the Treasury market.

Third, and consistent with the objective of funding the deficit at least cost to the taxpayer over time, we must consider the interests of all our investors and not unduly favor one group. The data should be used in ways that encourage the broadest Treasury securities investor base possible.

Fourth, Treasury more generally intends to use the data to improve Treasury market structure and technological evolution, with an eye toward developing policies, if needed, to protect the Treasury market from significant disruptions.

Fifth, we will foster cross-agency understanding of important characteristics of the Treasury market structure and validate findings via the Inter-Agency Working Group.

Finally, Treasury believes it is important to gather current views from market participants on TRACE data dissemination. I am announcing today a kick off of a robust period of outreach to gather the views of many of you at this conference and others in the coming weeks on this important issue. This will be an important undertaking with participation at the most senior level of Treasury. As with our outreach on other policy development, such as work on the Executive Order on the Core Principles, we are interested in hearing from the broadest range of constituents and understanding the granular implications and issues. We very much appreciate the active involvement of market participants in this exercise.

Treasury Report on the Core Principles for the Financial System: "A Financial System That Creates Economic Opportunity"

I would also like to take this opportunity to discuss a few other important work streams that are going on at the Treasury Department, which I think would be of interest to this audience, particularly the Second Report to the President on Core Principles of Financial Regulation, pursuant to Executive Order 13772, covering the breadth of U.S. capital markets including equity, fixed income and derivative markets. This builds on the initial review of the current regulatory landscape for depository institutions – banks and credit unions – that was released in mid-June.

The President directed Treasury to identify statutes and regulations that inhibit the operation of the financial system under the Core Principles -- essentially core values that align the performance of the financial system with the needs of consumers and businesses.

The Core Principles include:

- Empower Americans to make independent financial decisions and informed choices
- Prevent tax-payer funded bailouts
- Foster economic growth through vibrant financial markets with rigorous regulatory impact analysis
- Enable America's financial service companies to be competitive with foreign firms

- Advance American interests in international financial standard setting bodies
- Make regulation efficient, effective and appropriately tailored
- Restore public accountability within the regulatory agencies and rationalize the financial regulatory framework

Our work to study the changes that are needed included canvassing a large number of stakeholders. Through a series of industry, academic and advocacy gatherings and bilateral meetings we have sought to understand how regulation is impacting the financial system and how best to address the goals of the Core Principles.

Like the Treasury market, the U.S. capital markets are the largest, deepest, and most vibrant in the world and of critical importance in supporting the U.S. economy. The United States successfully derives a larger portion of business financing from its capital markets, rather than the banking system, than most other advanced economies. U.S. capital markets provide invaluable capital resources to our entrepreneurs and owners of businesses, whether they are large or small, public or private. Both our equity and debt markets provide investment opportunities to a broad range of investors, from large institutions to individuals saving for retirement.

Certain elements of the capital markets regulatory framework are functioning well and support healthy capital markets. For some elements, more action is needed to guard against the risks of a future financial crisis. Other elements need better calibration and tailoring to help markets function more effectively for market participants. There are significant challenges with regulatory harmonization and efficiency, driven by a variety of factors including joint rulemaking responsibilities, overlapping mandates, and jurisdictional friction.

In order to help maintain the strength of our capital markets, we need to constantly evaluate the financial regulatory system to consider how it should evolve to continue to support our markets and facilitate investment and growth opportunities, while promoting a level playing field for U.S. and global firms and protecting investors. Treasury has identified recommendations that can better align the financial system to serve issuers, investors, and intermediaries to support the Administration's economic objectives and drive economic growth.
In summary, our Report made recommendations in the following areas:

- Promoting access to capital for all types of companies, including small and growing businesses, through reduction of regulatory burden and improved market access to investment opportunities;
- Fostering robust secondary markets in equity and debt;

- Appropriately tailoring regulations on securitized products to encourage lending and risk transfer;
- Recalibrating derivatives regulation to promote market efficiency and effective risk mitigation;
- Ensuring proper risk management for central counterparties (CCPs) and other financial market utilities (FMUs) because of the critical role they play in the financial system;
- Rationalizing and modernizing the U.S. capital markets regulatory structure and processes; and
- Advancing U.S. interests by promoting a level playing field internationally.

We look forward to the opportunity to discuss our recommendations with the independent regulators, market participants, and other advocates and interest groups.

Once again, thanks for the opportunity to speak and your attendance here today.