Remarks by Under Secretary for Domestic Finance Nellie Liang at the 2021 Treasury Market Conference

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As prepared for delivery:

Good morning. It's a pleasure and honor to be here today. Having participated in a panel at last year's conference, I appreciate the opportunity to speak again at this conference in a completely different role, and to share some of Treasury's current priorities related to debt management and potential Treasury market reforms.

The Interagency Working Group on Treasury Market Surveillance, or IAWG, has co-hosted this event every year for the past 7 years. But the IAWG was founded several decades ago – in 1992 to improve oversight of the Treasury market and strengthen interagency coordination after the Salomon Brothers scandal – and since then IAWG staffs have worked together to monitor the Treasury market. More recently, IAWG staffs have been reviewing recent Treasury market disruptions and pursuing a program of analysis to inform policy making. IAWG-hosted forums like this allow us to communicate to the public our program of analysis and to encourage public engagement. Last week, the IAWG released a staff progress report, "Recent Disruptions and Potential Reforms in the U.S. Treasury Market," which is a key focus for discussion at today's conference.[1]

I want to acknowledge and thank many of those in the audience for the time and preparation they put into meeting bilaterally with Treasury's Office of Debt Management staff throughout the year. These meetings provide invaluable insights on a range of issues that the Office considers in its quarterly debt management decisions and ongoing review of Treasury market functioning.

My remarks today will feature two main topics. First, I will discuss Treasury's decisions regarding the issuance of Treasury debt since March 2020. These decisions reflect the need to finance the government and are relevant for the functioning of the secondary market over time. Second, I will discuss some of the main themes of the IAWG progress report. The report recognizes that technological advances and changes in trading and investment strategies are transforming some segments of the market that could lead to reduced liquidity in periods of

high stress. While some steps have been taken in recent years to strengthen the Treasury market, I think IAWG members should build on that progress, especially in the five specific policy areas that we highlight in the report. These collective efforts can help ensure that the Treasury market continues to be the deepest and most liquid market in the world and a central component of the U.S. and global financial systems.

The period since March 2020 has been a particularly eventful time in the world of Treasury debt management. As this audience is duly aware, the federal government's response to the COVID-19 pandemic required significant increases in borrowing (Figure 1). To fund the initial outlays of the CARES Act, the Treasury bill market was tapped first, consistent with its long-standing role as an issuance "shock absorber." The outstanding supply of T-bills nearly doubled from $2.7 trillion to $5.1 trillion between March and June of 2020 (Figure 2). As a way to manage its maturity profile, Treasury also began increasing auction sizes across the nominal coupon curve, first modestly in April 2020 and then substantially in the May 2020 quarterly refunding. For the most part, Treasury's financing response to the large, unexpected borrowing needs due to COVID-19 followed a playbook similar to the one used during the global financial crisis in 2008 to 2009.

The increase in nominal coupon auction sizes was implemented within the context of Treasury's framework of "regular and predictable" issuance. This framework has been a core tenet of Treasury debt management for more than four decades and, by supporting market liquidity, is instrumental to the goal of achieving the lowest cost funding for the taxpayer over time. In 2020, Treasury announced increases to all nominal coupon auction sizes at each of the May, August, and November quarterly refundings. As a result, by March of 2021, Treasury was issuing $1.07 trillion of nominal coupon securities each quarter, which represented a 69 percent increase to the $635 billion in quarterly supply from one year prior. The reintroduction of the 20-year Treasury bond at the May 2020 quarterly refunding – which had been decided in January that year before the onset of the pandemic – significantly contributed to the ability to increase supply and term out issuance.

Treasury's efforts to term out issuance helped reverse the impact of the initial heavy bill issuance on debt portfolio maturity metrics (Figure 3). For example, the weighted-average maturity of the portfolio, which had fallen to 62 months in June 2020 after the large and sharp increase in Treasury bills, increased to 72 months by September 2021, about the level during the five years preceding March 2020. Relatedly, the proportion of marketable debt maturing

within 1-year and within 3-years has declined to 29 percent and 52 percent, respectively, which also are near pre-COVID levels.

However, it became increasingly evident, as we approached the November 2021 quarterly refunding, that existing coupon auction sizes would likely provide excess borrowing capacity over the intermediate term (Figure 4). Absent changes, the supply of Treasury bills might need to be cut to undesirably low levels. The Treasury Borrowing Advisory Committee, or TBAC, for example, has previously recommended that Treasury bills be allocated a roughly 15 to 20 percent share of total debt outstanding, given investor demand for short-term Treasury securities and the need for the T-bill market to be able to perform as a shock absorber when financing needs increase unexpectedly. Absent a change to nominal coupon auction sizes, Treasury bills were projected to fall well below this recommended range by the end of FY2022. Although the TBAC also acknowledges that Treasury should maintain flexibility when considering this range, it has cautioned "against a sustained decline notably below this threshold."[2]

Given the intermediate-term borrowing outlook, as well as supply and demand dynamics for existing securities, Treasury announced at the November refunding its intention to modestly reduce auction sizes across its entire suite of nominal coupon securities during the quarter ending January 2022. In addition, we announced slightly larger reductions in the auction sizes of the 7-year note and the 20-year bond, as these tenors had been increased proportionally more than others over the prior year and a half (Figure 5). The announced plan to modestly reduce auction sizes reflects a strategy to only gradually change coupon issuance sizes in light of the uncertainty in the fiscal outlook and is consistent with the "regular and predictable" issuance framework. To the extent that we determine additional changes to auction sizes after January 2022 would be prudent, we would announce these adjustments in upcoming quarterly refunding statements.

Turning to the Treasury market more broadly, it is worth repeating, as we often do, that the Treasury market is the deepest and most liquid market in the world. The ability of the Treasury Department to substantially increase issuance in a short period of time even during the initial window of high volatility and uncertainty in financial markets in March 2020 is a testament to the market's depth and liquidity. There is no larger thoroughfare for global capital than the U.S. Treasury market, which averages over $600 billion in transactions every single day, with high volume days easily surpassing $1 trillion. Transaction costs have stayed

relatively low since March 2020 and auctions have performed well during the recent period of very high issuance (Figure 6).

If this was the end of the story, we would not be meeting each year at conferences like this. The Treasury market is changing continually. It has grown significantly relative to the balance sheets of traditional intermediaries, and technology and trading and investment practices have evolved substantially. The IAWG report reviews recent market disruptions, not only in March 2020, but a few others in recent years, to help identify common patterns. One common theme that has emerged is that demand for Treasury liquidity can surge suddenly, more than in the past, while intermediaries are less willing or have less capacity to respond. This was evident not only in March 2020, but also in September of 2019 and even October of 2014, as detailed in the report. When this imbalance emerges, it can lead to a deterioration in market functioning, which is can be particularly disruptive because market participants expect high levels of liquidity at all times. Another theme is that the official and private sectors may have limited real-time visibility into positions and flows driving market dislocations.

Before highlighting areas for potential reforms, it is worth a reminder that the primary objectives of the official sector for the Treasury market are to efficiently finance the federal government, support the broader financial system, and implement monetary policy. The Treasury market is used for diverse purposes, so it is important to ground policy ideas in these public objectives. For example, when considering views on potential improvements to secondary market functioning, Treasury assesses potential improvements also through the lens of financing the government at the lowest risk-adjusted cost over time.

In the IAWG report, the staffs identified six principles that they view as useful in guiding Treasury market policy in order to achieve the official sector's objectives. These principles embrace resilient and elastic liquidity, transparency, efficient price discovery, economic integration across markets, financial stability, and resilient infrastructure. Each one of these principles are described in more detail in the paper.

To achieve such lofty principles will take practical, sustained efforts by the official sector working with the private sector, including investors, market makers, and service providers. We expect and encourage market participants to continue to pursue innovations that improve liquidity provision and reduce bottlenecks in intermediation when there are surges in demand for liquidity in stress periods. Complementing these efforts should be concrete workstreams within the official sector. The IAWG report highlights five workstreams including: improving resilience of market intermediation; improving data quality and availability; evaluating

expanded central clearing; enhancing trading venue transparency and oversight; and assessing effects of fund leverage and liquidity risk management practices. None of these workstreams is a standalone solution. Instead, each complements others to jointly improve Treasury market functioning.

Steps related to some aspects of these workstreams are already underway. For example, two standing repo facilities – both the domestic Standing Repo Facility and Foreign and International Monetary Authority Facility– announced by the Federal Open Markets Committee in July 2021 can help to alleviate some of the liquidity pressures in financing markets that were evident in both September 2019 and March 2020, as well as improve the transmission of monetary policy. The domestic facility is expanding eligibility beyond primary dealers to include commercial banks.[3] Likewise, the SEC is studying, as Chair Gensler just discussed, the potential broader application of Reg ATS and SCI to systems that trade Treasury securities to bring additional transparency and oversight of these platforms. This work recognizes the advances in electronic trading in recent years that have led to significant changes in where trading occurs.

In addition, to improve data quality and transparency, the Financial Industry Regulatory Authority (FINRA) has proposed the collection of Treasury secondary market transactions sooner than end of day through the Trade Reporting and Compliance Engine, or TRACE, and the Federal Reserve Board has adopted a new rule requiring banks to report transactions.[4] These efforts will significantly increase the quality of data available to the official sector. Treasury has been working with FINRA on these issues for the past year-and-a-half. Looking ahead, we will consider ways to improve transparency about transactions, such as providing data at a higher frequency, building on lessons learned from the recent expanded reporting of weekly volumes and recognizing investors' needs to be able transact quickly in large quantities.

In addition to options for improving transparency, the IAWG considered the official sector's needs for greater visibility into position and transaction data. In particular, there would be clear benefits from collecting transaction data for bilateral repo that is not centrally cleared. These additional data would be an important complement to the successful collection of data by the Office of Financial Research on other segments of the repo market, which yielded important (yet incomplete) insights in periods of disruptions such as September 2019.

Other workstreams are at earlier stages of consideration. For example, expanded central clearing appears promising in terms of potential improvements in risk management and

efficiencies from netting across all counterparties. But these benefits vary across market segments; for example, the capital efficiencies from netting likely are larger for repo than for cash securities transactions. In addition, consideration has to be paid to potential higher costs of participating in the market, the potential risks of expanded central clearing, such as increased concentration of risk at the central counterparty.

The IAWG also supports the Financial Stability Oversight Council's (FSOC) work on open-end bond mutual funds and hedge funds. As mentioned in the report, open-end bond mutual funds and hedge funds were two of the largest participants in the March 2020 "dash for cash." The IAWG plans to build on FSOC's analysis of risk management practices and data transparency, and how they affect market liquidity in stress periods.

As these efforts continue, Treasury welcomes continued engagement with academics and market participants such as those attending and speaking at this conference today, on the potential costs and benefits of the options of the five workstreams. We plan to continue working with the IAWG and intend to communicate further progress and conclusions to the public as they develop.

To conclude, I want to thank everyone listening for the many ways you work to support an efficient and stable U.S. Treasury market. I know we share a common goal to ensure that the Treasury market continues to fulfill its vital roles in the domestic and global financial markets. I look forward to our future discussions. Thank you.

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[1] https://home.treasury.gov/system/files/136/IAWG-Treasury-Report.pdf

[2] https://home.treasury.gov/news/press-releases/jy0463

[3] https://www.federalreserve.gov/monetarypolicy/standing-overnight-repurchase-agreement-facility.htm

[4] https://www.federalregister.gov/documents/2021/10/28/2021-23432/agency-information-collection-activities-announcement-of-board-approval-under-delegated-authority