SYSTEMIC LIQUIDITY AND FINANCIAL SYSTEM RESILIENCE

Thank you for the invitation and opportunity to speak to you today. I will talk today about systemic liquidity risk and current efforts of Treasury and the financial regulators to reduce these risks to keep the financial system resilient. Much of the work is fundamental and long-standing, but the financial system is continually evolving. In addition, the demand and supply of liquidity can change quickly, revealing vulnerabilities in unexpected places.

But before I discuss that agenda, I’d like to recognize the important contribution of ISDA in the collaborative work of policymakers and market participants in the transition away from LIBOR. We are fast approaching June 30, 2023, the final publication date of the USD panel-based LIBOR. ISDA has been a key contributor to the Alternative Reference Rates Committee’s work to transition interest rate swaps. The system-wide change has been a tremendous decade-long effort, but there is still some more work to be done, especially in legacy U.S. loans. We are so close, and it’s vital that we finish what we set out to do.

SYSTEMIC LIQUIDITY RISK

Maturity and liquidity transformation are at the center of our modern financial system. Banks and non-bank financial intermediaries (NBFIs) both provide households and businesses with ready access to the liquid resources they need for daily transactions, while providing them the stable financing needed to make productive, long-term investments. Liquidity transformation is often bundled with other necessary activities. For example, in addition to transforming liquid deposits into term loans, banks evaluate credit risks and monitor borrowers. Similarly, NBFIs provide liquidity to markets but also identify productive investment opportunities, reduce distortions across markets, and facilitate price discovery.
Unfortunately, as we have seen all too clearly with the recent bank failures and the March 2020 market panic, inadequate management of liquidity risks when there are significant changes in system-wide liquidity can have grave consequences for financial intermediaries and markets. If firms and markets are not able to adapt to such changes, the resulting frictions can do real and lasting harm to financial stability and macroeconomic performance. So today I’d like to talk about the notion of *systemic liquidity risk* – what it is, and what we can do to mitigate it. We saw a clear example of a systemic shock to demand for liquidity during the so-called “dash for cash” in early 2020. The onset of the COVID-19 pandemic led to a worldwide shift in preferences away from risk assets and toward cash and cash-like assets. Given the magnitude of the uncertainty created by the then unfolding pandemic, a shift in risk preferences was not, in itself, an indication of systemic dysfunction. However, there were also signs of strains in some financial institutions and markets.

Bond mutual funds saw unprecedented outflows, forcing them to sell large quantities of corporate and Treasury debt to meet redemptions, and cash flowed out of prime money market funds holding commercial paper and CDs. Bond and commercial paper spreads ballooned, trading became extremely difficult, and businesses could not access credit markets. Perhaps most distressing of all, there were signs of illiquidity in the vital U.S. Treasury market, particularly for longer-dated and off-the-run securities. Had all these market stresses not been addressed quickly and forcefully by the Federal Reserve, Treasury, and Congress, it would have been much more difficult for the economy to respond to, and recover from, the COVID crisis.

More recently, we have seen how a shift in the supply of liquidity – in the form of monetary policy tightening necessary to combat the increase in inflation -- can create stresses for financial intermediaries. Banks with short-term liabilities but long duration assets have faced market value losses as interest rates have moved up notably since early 2022, and two banks failed suddenly. Systemic actions by the government, as well as the strong capital and liquidity positions of the banking system, prevented the depositor runs from spreading and becoming a systemic banking crisis. In September 2019 we saw a less dramatic example of how a shift in the supply of liquidity can contribute to market stress when a temporary drain in reserve balances at banks led to a significant spike in overnight funding rates which were reversed after the Fed announced interventions in funding markets.

To help better prepare the financial system for shifts in systemic liquidity demand and supply, financial regulators have been working to identify areas of vulnerability. Even before the disruptions of early 2020, the Financial Stability Oversight Council (FSOC) and the Financial Stability Board (FSB) had been looking at activities of NBFIs that could make the system more vulnerable to liquidity shocks. And after the March 2020 dash for cash, the Inter-Agency Working
Group on Treasury Market Surveillance (IAWG) embarked on an aggressive work program to enhance the resilience of the U.S. Treasury market. Following the recent bank failures, regulators are looking closely at duration risk and liquidity risk management at banks. Some of this work is quite far along; other work is just getting started. In the remainder of my talk, I’ll discuss our thinking and progress to mitigate systemic liquidity risk in three critical segments of the financial system: banking, NBFIs, and the Treasury markets.

**BANKING**

In the banking sector, the Federal Reserve Board’s report on SVB traces its failure directly to poor interest rate and liquidity risk management. What lessons can be learned from this incident about the banking system’s exposure to systemic liquidity risk more broadly?

First, it’s important to recognize that the character of the problems faced by banks like SVB and Signature are very different from those we saw in the banking system 15 years ago. Washington Mutual, IndyMac, and the other commercial banks and thrifts that failed or were acquired during the global financial crisis, failed primarily because they had insufficient capital to cover bad, low-quality mortgage loans. Most of these loans could not be repaid. Today, house prices are stable and mortgage lending standards are far, far better. The banking system as a whole has much more capital and liquid assets due to post-financial crisis regulatory reforms.

Nonetheless, systemic interventions were needed to shore up public confidence in the banking system after SVB and Signature failed. SVB was closed after it was unable to raise capital to cover interest rate risk losses on default-free government securities, and its depositors, nearly all uninsured and highly concentrated, ran at extraordinary speed. The dramatic failure escalated fears and there were signs that uninsured depositors were running from other banks. To prevent even broader contagion, the boards of the FDIC and the Federal Reserve unanimously recommended, and Secretary Yellen approved after consulting with the President, systemic risk determinations that allowed the FDIC to complete its resolutions of the two banks in a way to fully protect all of the banks’ depositors. At the same time, the Federal Reserve created the Bank Term Funding Program, a new facility to provide term funding collateralized by government securities. This program, along with traditional discount window lending, bolstered liquidity and helped all banks meet depositor demands.

Deposit flows from smaller and medium-sized banks appear to have stabilized, though stock prices remain under pressure. Earlier this month, First Republic failed after it was unable to raise private capital even after its deposits had stabilized. But notably it was resolved in a way that protected all depositors without the need for a systemic risk determination.
Going forward, banks and regulators will review how liquidity risk and interest rate risk management and regulation may need to adjust given the effects of changes in technology and social media on deposits – their sensitivity to interest rates and their stability in stress. In addition, earlier this month the FDIC published a review of the deposit insurance system and suggested reform options that could be considered. [ii] Treasury looks forward to collaborating with the FDIC, the Federal Reserve, and other agencies and stakeholders to evaluate recent events and consider potential policy responses.

**NON-BANK FINANCIAL INTERMEDIARIES**

While the most recent revelation of systemic liquidity risk is at mid-sized banks, we need to continue our reforms, domestic and global, for nonbank financial intermediaries. For many households and businesses, money market funds serve as close substitutes for bank deposit accounts. More broadly, a variety of non-bank financial intermediaries, including mutual funds, private funds, insurers, and pension funds, offer a diversity of ways to channel savings toward credit. Relative to GDP, credit provided to households and businesses by nonbank intermediaries has more than doubled since 1985, while credit provided by banks has remained relatively flat. This suggests that nearly all private credit growth in the last forty years has been at nonbanks.

Open-end bond mutual funds and prime money market funds provide credit, but they have well known vulnerabilities. While assets in open-end bond and loan funds are marked-to-market and directly passed through to investors, there is a liquidity mismatch in the fund structures that advantages early movers. Investors in bond and loan open-end mutual funds can redeem fund shares daily, but, unlike most equities, the underlying bonds and loans cannot be sold as quickly without significant transaction costs.

This mismatch can have systemic consequences because of highly correlated portfolios and investor behavior which can lead to dysfunction in periods of stress, such as in March 2020. In addition, prime money market funds that are generally expected to pay a fixed net asset value also can face runs if they hold ‘information-sensitive’ assets, that is those with quality that can come into question under stress. Last year, the SEC proposed new rules aimed at reducing run incentives at prime and tax-exempt money market funds and for open-end funds. [iii]

Excessive leverage can make it more difficult for financial intermediaries to manage systemwide shocks to demand or supply of safe assets, amplifying the effects of such shocks. We saw this in March 2020, when the normally thin basis between cash Treasuries and Treasury futures widened as leveraged traders unwound arbitrage positions amid high market volatility, and last September, when deleveraging by liability-driven investment (LDI) funds contributed to dysfunction in the UK
gilt market. And, more recently, in the days immediately following the bank failures, substantial margin calls from clearinghouses to highly leveraged hedge funds appears to have added to Treasury market volatility.

Staff at FSOC member agencies have been working to improve monitoring systems to identify potential emerging financial stability risks posed by highly-leveraged hedge funds. Work in this regard has been focused primarily on common, broad practices and activities, rather than on individual institutions. For example, based on a recent pilot data collection, a significant share of bilateral repo transactions collateralized by Treasury securities – a key source of hedge fund leverage – appear to be traded with zero haircuts. Regulators are assessing the potential for this practice or others that could lead to fire-sale dynamics, and will consider policy options to reduce any systemic consequences. In January, the Office of Financial Research (OFR) proposed to begin a permanent data collection on this $2 trillion market, which would allow regulators to monitor the market and identify emerging market vulnerabilities.

U.S. TREASURY MARKETS

Let me turn now from financial institution resilience to market liquidity. The relationship between financial institution resilience and market liquidity is a two-way street. Poor liquidity risk management or excessive leverage by institutions can cause market liquidity to deteriorate during times of stress. At the same time, many financial institutions rely on liquid markets in managing their risks. Ensuring that our markets can function well, even when faced with large shocks to demand or supply, is critical to the resilience of our financial system. And nowhere is this more important than in the market for U.S. Treasury securities.

$24 trillion in marketable Treasury securities are held as safe assets and for liquidity risk management. Trading volumes are large; on most business days more than $600 billion in Treasury securities change hands. And, as this audience knows well, Treasury yields underpin pricing for trillions in interest rate derivatives.

The IAWG has continued to make progress on its agenda to improve Treasury market resilience, and I'll mention a few efforts. First, to increase transparency in the cash secondary market, Financial Industry Regulatory Authority (FINRA) began publishing daily aggregate volume data earlier this year, after having moved to weekly data in March 2020. In addition, Treasury is working on the potential release of some secondary market transaction-level data. We have continued to gather information, including through a January 2023 survey of primary dealers. We will proceed carefully and likely will start with on-the-run nominal coupons, with end-of-day dissemination and
trade sizes capped to ensure the market continues to provide the ability to move significant positions.

Second, regulators are considering whether changes to the way Treasury securities are traded and cleared could make these markets more robust. Last September the SEC proposed new rules that would expand central clearing to cover a broad swath of currently uncleared Treasury markets transactions.[iv]

Broader clearing has the potential to help make the secondary markets for Treasury securities more resilient by reducing counterparty risks and by increasing netting of repo positions, which could make it easier for institutions to expand capacity when demand for intermediation spikes. Over the longer run, broader central clearing could facilitate some all-to-all trading in Treasury securities with a wider range of participants. Of course, when considering next steps, potential costs of expanded central clearing, such as higher costs in normal times and increased concentration of risks at a clearinghouse, also will be considered.

Finally, last week the Treasury Department announced plans to develop a regular buyback program for Treasury securities.[v] This program will help to bolster market liquidity by providing a predictable opportunity for market participants to sell less-liquid, off-the-run securities.

Treasury is designing a program to offer to buy securities in a regular and predictable manner, starting with modest, conservative amounts of between $5 and $10 billion monthly. The program is not intended to meaningfully change the overall maturity profile of marketable debt outstanding and it will not be used to mitigate episodes of acute market stress. Treasury expects to begin in 2024. Treasury will continue to engage with market participants as it designs the specific program details and will provide updates on its plans in its quarterly refunding announcements.

CONCLUSION

Before closing, I’d like to briefly take note of one other area of high importance to the Treasury Department where ISDA and its members are playing a central role: the development of voluntary carbon markets.

We at Treasury and other financial regulators are focused on how best to promote a voluntary carbon market that has appropriate guardrails and market and credit integrity. Climate change is a global challenge that will require both government action and private capital to solve. We hope that with public-private collaboration, VCMs can live up to their potential to mobilize significant capital for high-integrity climate mitigation activities in the future. The VCM work that ISDA has
recently undertaken – from analyzing the U.S. regulatory context for credit trading to developing standardized definitions for credit transactions – has been essential to progress made to date.

Ensuring that our financial system is robust to systemic shocks to liquidity demand and supply is an ongoing process. Our innovative and dynamic financial system is always evolving to meet the changing needs of America’s households and businesses. Because the financial system is not standing still, financial regulators can’t stand still either. Today I’ve outlined some of the ways we’ve tried to learn from recent events, and some of the steps we’re taking to safeguard financial stability. We look forward to continuing to partner with ISDA, its members, and the broader financial community as we continue in our shared work to keep our financial system strong.

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