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US Treasury Market Resilience and Central Clearing

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The market for Treasury securities is the largest and most important financial market in the world. Treasury rates are the benchmark for pricing all financial assets. Resilient markets for Treasury securities are essential to financing the U.S. government and to the stability of the U.S. economy. The flash rally of 2014, the Treasury repo market stress of 2019, and the Covid-19 shock of 2020 have shown that the Treasury market can become illiquid under stress.

According to the Congressional Budget Office, the publicly held federal debt-to-GDP ratio could increase to 115% in a decade and over 180% thirty years from now. While global systemically important banks (GSIBs) have become more resilient due to the post- global financial crisis higher capital and liquidity requirements, their market making capacity have decreased. In recent years, a large share of Treasury securities trading has been accounted for not by bank-affiliated broker-dealers, but by principal trading firms (PTFs) that have become important liquidity providers in electronic and high frequency interdealer markets. Potential supply-demand imbalances in the US Treasury market may lead to more illiquidity episodes in the future. Treasury market reforms and fiscal reforms can reduce risks to the stability of the Treasury markets.

The main goal of the Treasury market reforms has been increasing, diversifying, and stabilizing the market making capacity in these markets. A broader central clearing mandate has been one of the main elements of the reform program. Broader central clearing can bring more transparency to the secondary markets, both the cash and repo parts. Under robust capital regulation, governance, and risk management frameworks, central counterparties (CCPs) may reduce risks to the stability of the Treasury market. For instance, well-designed CCP margin rules may reduce the buildup of leverage by the buy side firms in cash and repo markets. Recent research discusses CCP capital regulation, governance, and risk management practices and outlines a risk-based framework that may be used for more effective capital regulation of CCPs.

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