

For release on delivery
10:35 a.m. EST
November 16, 2023

The 2023 U.S. Treasury Market Conference

Remarks by

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at

Federal Reserve Bank of New York

New York, New York

November 16, 2023

I am pleased to join you today at the ninth annual U.S. Treasury Market Conference.¹ This event is a joint effort by the agencies that make up the Inter-Agency Working Group on Treasury Market Surveillance and serves as a reflection of the group's ongoing, crucial collaboration.

The flash rally in the Treasury market in October 2014 revealed a need for a deeper understanding of Treasury market functioning. The report that the joint agencies produced in response sheds light on how the market had evolved. Since then, this annual conference has provided a forum for the official sector to come together with market participants and the scholarly community to identify ways to bolster the resilience of the Treasury market. This coordination has been important as we have worked together to study subsequent bouts of market stress. I am proud of the work done by the staff of the agencies and the private sector participants and wholeheartedly support our continued collaboration to advance work in this area.

Before I dive into my remarks, I want to thank the Federal Reserve Bank of New York for hosting this event once again and for its ongoing thought leadership on Treasury market functioning. I also wanted to acknowledge the important leadership of the U.S. Department of the Treasury in convening both the agencies and the private sector to analyze longer-term structural issues and to address emergent issues.

The Importance of the Treasury Market

Let me start by sharing a few thoughts on why I think work on Treasury market structure is so important to the public and the Federal Reserve.

¹ The views expressed here are my own and not necessarily those of my colleagues on the Federal Reserve Board and the Federal Open Market Committee.

First, Treasury securities are the primary means of U.S. federal government financing. The American people rely on the Treasury market to function well, so that the Treasury can issue debt efficiently.

Second, the market for Treasury securities underpins the pricing of assets across the financial system, providing benchmark rates on which other assets are priced. As such, the Treasury market is a key component of the transmission of monetary policy for the Federal Reserve. In addition, open market operations in the Treasury cash and repo markets have long been central to how the Fed implements monetary policy. The Treasury market also helps us understand investors' views on the outlook for growth and inflation. The insights we gain from studying the evolution of Treasury yields across the curve help us understand financial conditions that affect borrowing costs for businesses and households.

Finally, Treasury securities serve as reserve assets for private savers, financial institutions, and other countries. For example, Treasuries comprise a significant portion of banks' high-quality liquid assets. In times of stress, certain sources of funding can, in some cases, exit quickly. In such cases, access to immediately available liquidity is important, and thus, even in normal circumstances, helps promote safety and soundness. This means that markets for high-quality liquid assets need to be deep and well-functioning in a variety of conditions. Of course, these holdings cannot completely insulate banks from acute risks—a point I will discuss later—but having a readily available liquidity buffer to meet outflows can provide firms with some flexibility to adjust their balance sheets in response to changing market or firm conditions.

Interest Rate Risk Management

The events in March made it clear how important it is for banks to properly manage their interest rate risk, so I want to spend a few minutes on this topic. To start, I would say that years of very low interest rates led to complacency at some financial institutions about the degree to which banks needed to manage interest rate risk, including in high-quality liquid asset portfolios. As in the case of Silicon Valley Bank, supervisors could also have done more to act forcefully when they identified problems.²

Savings soared during the pandemic as normal spending was disrupted, and government payments to households and businesses increased significantly to avert a massive economic contraction. As a result, bank deposits grew rapidly. To manage balance sheet growth, understandably, a number of banks invested in securities, including Treasury securities. But investing heavily in fixed-rate, long-duration assets without appropriate interest rate risk management led to problems in some cases. As described in our *Financial Stability Report*, as the Federal Open Market Committee (FOMC) raised the policy rate to combat inflation, yields increased across the curve and some banks experienced sizable declines in the fair value of these assets.³

The higher rate environment also affected the liability side of banks' balance sheets. The outflow of bank deposits into money market funds and other alternative

² Board of Governors of the Federal Reserve System, "Federal Reserve Board announces the results from the review of the supervision and regulation of Silicon Valley Bank, led by Vice Chair for Supervision Barr," news release, April 28, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230428a.htm>.

³ Board of Governors of the Federal Reserve System, *Financial Stability Report* (Washington: Board of Governors, October 2023), <https://www.federalreserve.gov/publications/files/financial-stability-report-20231020.pdf>.

short-term instruments, for the most part, has been and remains both anticipated and orderly. Unfortunately, a few firms had a combination of both poor interest rate risk management and weak liquidity risk management. The combination led to failure, as staff documented in my report on Silicon Valley Bank.⁴

The contagion from the failure of Silicon Valley Bank, Signature Bank, and eventually First Republic was stemmed from spreading further in large part by the invocation of the systemic risk exception, permitting the Federal Deposit Insurance Corporation to fully pay out on uninsured depositor claims, and the establishment of the Bank Term Funding Program, which provides a long-term source of liquidity secured by Treasuries and agency securities at par. Deposit flows have reverted to their normal patterns.

A few observations are in order, however. I will start with the liability side of bank balance sheets. As I mentioned, as yields on deposit alternatives, such as money funds, increased as our tightening cycle took hold, banks found they needed to start paying higher interest rates to retain deposits and pay up for alternative sources of funding as they lost deposits. A recent paper by three members of the Federal Reserve staff discusses how deposit betas rise in a dynamic way as interest rates rise, rather than having a static relationship to rising rates. This paper formalizes the intuition that banks must be prepared for potential declines in deposit duration as rates rise.⁵

⁴ Board of Governors of the Federal Reserve System, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank* (Washington: Board of Governors, April 2023), <https://www.federalreserve.gov/publications/review-of-the-federal-reserves-supervision-and-regulation-of-silicon-valley-bank.htm>.

⁵ Emily Greenwald, Sam Schulhofer-Wohl, and Joshua Younger, "Deposit Convexity, Monetary Policy, and Financial Stability," Working Paper 2315 (Dallas: Federal Reserve Bank of Dallas, October 2023), <https://www.dallasfed.org/-/media/documents/research/papers/2023/wp2315.pdf>.

Looking at the asset side of bank balance sheets, most banks do not need to record unrealized gains and losses of their security portfolios in regulatory capital. Banks have an incentive to avoid selling “hold to maturity” (HTM) securities because selling even a portion of a portfolio “taints” the entire portfolio since it requires recognizing changes in value. But, even if not recognized from an accounting or capital standpoint, losses on long-duration asset portfolios can still lead to challenges. Federal Reserve supervisors have stepped up their supervision of interest rate and liquidity risk, given what we have learned from recent experience, and they will continue to work with banks to ensure their balance sheets are resilient to a variety of conditions.⁶

The Importance of Contingency Funding Preparedness

That brings me to the importance of contingency funding planning and preparedness. Banks don’t need to sell securities to gain liquidity value from them if they can borrow against them. But firms can face challenges in significantly ramping up funding in private markets, such as repo markets, particularly if they do not tap those markets regularly.

In July, the Board, along with the other relevant agencies, updated guidance to highlight that banks should maintain a broad array of funding sources, including the discount window, which can be accessed in a range of circumstances.⁷ Liquidity sources that are not regularly tapped or tested may not function as expected when most needed.

⁶ Board of Governors of the Federal Reserve System, *Supervision and Regulation Report* (Washington: Board of Governors, November 2023), <https://www.federalreserve.gov/publications/files/202311-supervision-and-regulation-report.pdf>.

⁷ Addendum to the Interagency Policy Statement on Funding and Liquidity Risk Management: Importance of Contingency Funding Plans, <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230728a1.pdf>.

I have recently discussed the importance of discount window preparedness. Last month, I outlined how the discount window is an important tool of both monetary policy and financial stability.⁸ It is an important tool of monetary policy because, with the primary credit rate set at the top of the target range, it supports rate control. It is also an important tool of financial stability because it provides ready access to liquidity, regardless of market conditions. Other sources of funds to banks, even the Federal Home Loan Banks, are dependent on a functioning private-sector market to provide liquidity to their customers. When the market is not working, such sources of funding and liquidity come under strain.

The discount window, however, can play these important roles only if eligible institutions are both willing and ready to use it. This means that it is important that banks establish borrowing arrangements, pre-pledge collateral, and engage in test transactions at regular intervals.

I also want to highlight the standing repo facility (SRF). The SRF was established by the FOMC to help keep the federal funds rate within the target range if pressures arise in short-term funding markets, with the rate currently set at the top of the target range.⁹

This facility can be useful to both primary dealers and banks because it gives them another venue to raise liquidity against Treasury securities and other eligible securities. It is encouraging to see an uptick in interest among banks to join the SRF as

⁸ Michael S. Barr, “Monetary Policy and Financial Stability” (speech at the Forecasters Club of New York, New York, October 2, 2023), <https://www.federalreserve.gov/newsevents/speech/barr20231002a.htm>.

⁹ Committee discussions about the design of the standing repo facility can be found in Board of Governors of the Federal Reserve System, “Minutes of the Federal Open Market Committee, June 15–16, 2021,” press release, July 7, 2021, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20210707a.htm>.

counterparties, with 10 banks onboarded as counterparties in the last year, bringing total coverage to about half the assets of the banking system. I am also encouraged to see that there is now a broader appreciation among eligible institutions that Federal Reserve liquidity facilities are an important part of making sure that firms can weather a variety of market conditions. It is important that firms are ready to tap facilities when the rates they face from private market participants are higher than the rates offered on the facilities. In this way, the facilities can serve to support interest rate control and broader market functioning.

Leverage in the Treasury Market

Turning to risks on the horizon, the Federal Reserve continues to study leverage in the Treasury market, and we have also been contributing to the Financial Stability Oversight Council (FSOC) work to study this issue as well.

I want to recognize that leveraged trading, including in the so-called basis trade, can play an important role in capital markets. Basis trading serves a valuable function of market efficiency, improving the connection between cash and futures pricing and facilitating access to futures for investing and risk management. Leverage allows market participants to arbitrage away relatively small pricing discrepancies, enhancing the integration of prices across economically equivalent instruments and markets.

But leverage can also increase risks to both market participants and to Treasury market functioning and must be managed appropriately by both investors and their counterparties, including through collecting margin to manage counterparty risk.

Staff at the Federal Reserve and other agencies have done important work to analyze leverage in the Treasury market using available data.¹⁰ These studies have found that hedge funds are significant investors in Treasury cash, derivatives, and repo markets; that their highly leveraged positions in Treasury markets are facilitated by very low, or even zero, haircuts on their repo financing; and that demand for this leverage is highly concentrated among a handful of large hedge funds. Moreover, liquidation of leveraged Treasury positions by hedge funds appears to have contributed to the Treasury market stress in March 2020.

All of us need to better understand this activity. The Federal Reserve collects information on the triparty repo market through its oversight of the Bank of New York Mellon, and the Office of Financial Research (OFR) collects detailed information on repo trading centrally cleared through the Fixed Income Clearing Corporation. But as discussed at this conference, there is much less information on the non-centrally cleared bilateral repo market, where much of this activity takes place. OFR's proposal to collect information on this market segment on an ongoing basis is an important step forward, and I look forward to their final rulemaking.

The Board also contributes to the official sector's visibility into the Treasury market by requiring banks that meet certain threshold requirements to report transactions

¹⁰ Ayelen Banegas, Phillip Monin, and Lubomir Petrusek, "Sizing Hedge Funds' Treasury Market Activities and Holdings," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, October 6, 2021), <https://www.federalreserve.gov/econres/notes/feds-notes/sizing-hedge-funds-treasury-market-activities-and-holdings-20211006.html>; and Ayelen Banegas and Phillip Monin, "Hedge Fund Treasury Exposures, Repo, and Margining," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, September 8, 2023), <https://www.federalreserve.gov/econres/notes/feds-notes/hedge-fund-treasury-exposures-repo-and-margining-20230908.html>.

to TRACE.¹¹ Under this rule, 22 depository institutions began submitting their Treasury and agency MBS transactions on a daily basis to TRACE last fall. Although the bulk of transactions in the Treasury market are conducted through FINRA members, the addition of reporting by depository institutions has helped to ensure more complete coverage of the market, and we will continue to consider enhancements so that the collection aligns with FINRA's reporting rules for its members and ensures consistent coverage of the market.

While getting more and better data is crucial for fully understanding Treasury markets, some of the analysis outlined in recent research raises questions about how the official sector can further support the resilience of the Treasury market.

The Financial Stability Oversight Council's Hedge Fund Working Group has done excellent work to identify risks and offer recommendations to the council on leveraged trading.¹² At the Federal Reserve, we will continue to work with the other agencies and market participants to identify and address risks to our supervised institutions and to the resiliency of Treasury markets. For instance, the capital requirements applicable to banks are one of our primary tools to help ensure that banks have sufficient capital to weather stressful conditions and continue to lend in good times and bad. We and the other banking agencies recently sought comment on a proposal to revise these requirements to better reflect the risk of bank activities, and we are interested

¹¹ Agency Information Collection Activities: Announcement of Board Approval Under Delegated Authority and Submission to OMB, 86 Fed. Reg. 59,716 (October 28, 2021), <https://www.govinfo.gov/content/pkg/FR-2021-10-28/pdf/2021-23432.pdf>.

¹² Financial Stability Oversight Council, *2022 Annual Report* (Washington: Financial Stability Oversight Council, 2022): 44, <https://home.treasury.gov/system/files/261/FSOC2022AnnualReport.pdf>.

in views on whether the proposal achieves that goal. The people in this room and those watching online are well positioned to provide us detailed feedback on the capital proposal, including how different components of the rule could affect different markets, so I thank you in advance for your thoughtful contributions.

I also want to highlight that the preamble to the proposal asks commenters for feedback on whether and to what extent sovereign securities should be subject to minimum collateral haircut floors, including, for example, repo-style transactions in which a banking organization lends cash against Treasury securities.¹³ While we are in early stages of exploring these issues, we appreciate commenter views on these issues.

I have also taken note of some recent studies, including a paper presented at Jackson Hole, that have looked at additional factors that could support Treasury market functioning, including a move to broader central clearing, all-to-all trading, and also ensuring that risk-based capital requirements, rather than the enhanced supplementary leverage ratio, drive dealer balance sheet allocation.¹⁴ We are continuing to study these and other topics.

Managing Cyber Risk

I want to wrap up today by reiterating the importance of managing cyber risk. Cyber threats are constantly evolving, and we can expect them to become increasingly sophisticated as technology advances. It is vital for financial institutions and those who

¹³ Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64,028 (September 18, 2023), <https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf>. See questions 54 and 55.

¹⁴ Darrell Duffie, “Resilience Redux in the U.S. Treasury Market,” August 13, 2023, https://www.kansascityfed.org/Jackson%20Hole/documents/9726/JH_Paper_Duffie.pdf.

provide critical services to them to understand vulnerabilities in their systems and make necessary investments to remedy those vulnerabilities. These preventative measures are necessary but not sufficient. It is also imperative for firms to build resilience to cyber incidents by developing and regularly testing business continuity plans. This is another area where we can never become complacent and where contingency preparedness for an array of scenarios is important.

Thank you.