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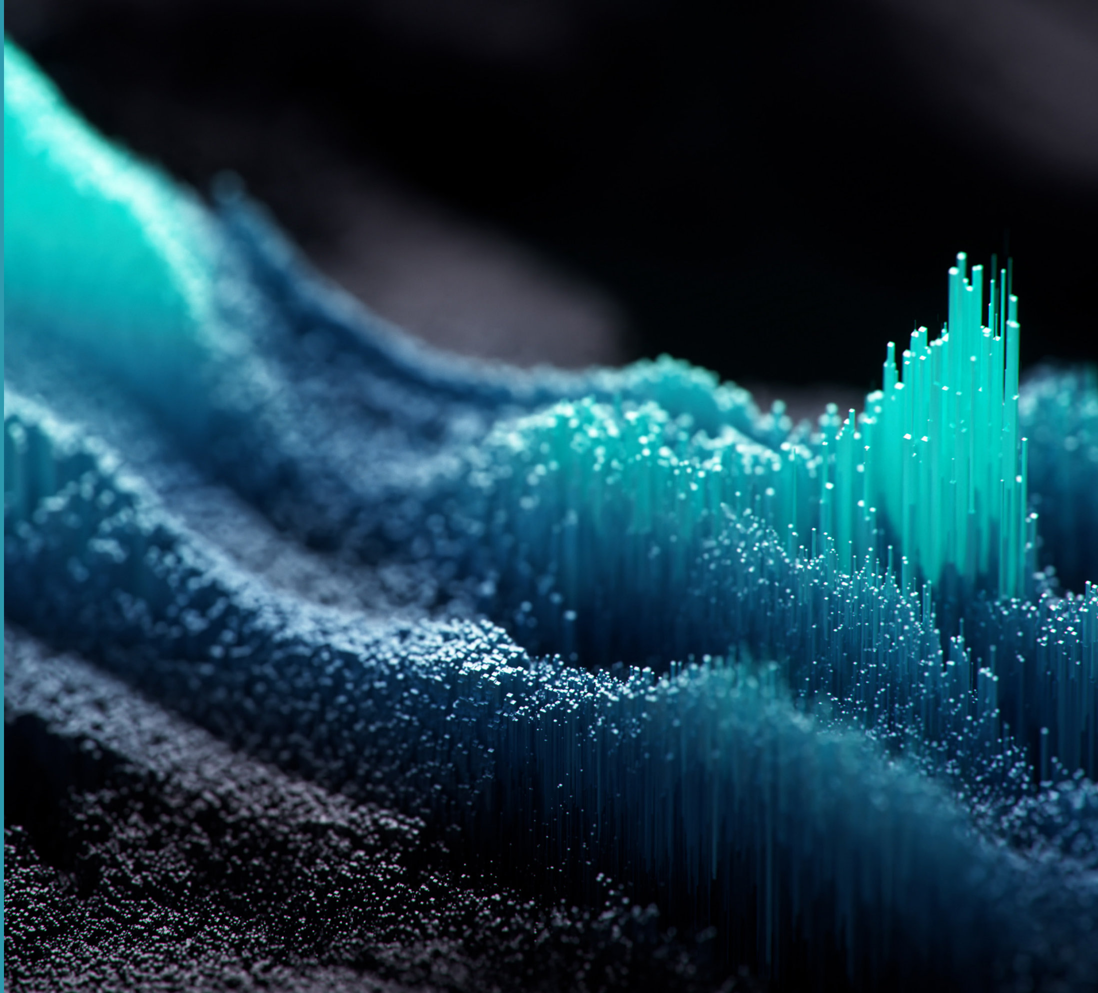

MARKET STRUCTURE AND GROWTH

JANUARY 23, 2025

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The U.S. Treasury market, the most liquid government securities market in the world, plays a pivotal role in the global economy. U.S. Treasuries serve as a benchmark for global interest rates and play a key role in monetary policy and global financial stability.

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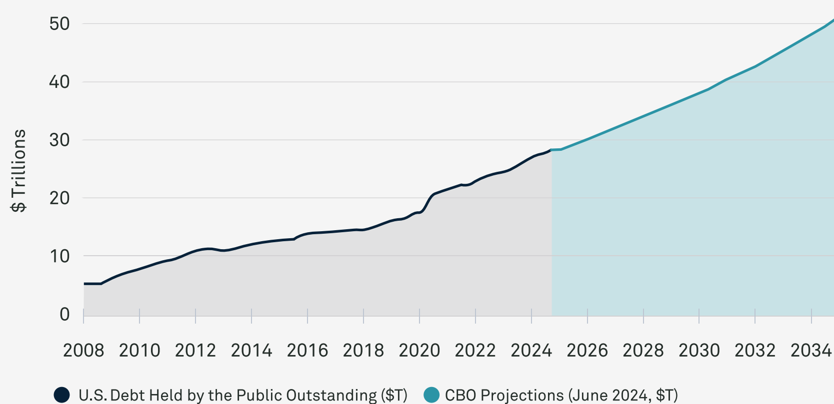
FIGURE 1: OUTSTANDING U.S. DEBT HELD BY THE PUBLIC POISED FOR CONTINUED GROWTH



U.S. Debt Held by the Public Outstanding ($T) · CBO Projections (June 2024, $T)

Source: Bloomberg, quarterly, non-seasonally adjusted. June 2024 CBO debt projections reflected.

FISCAL GROWTH AND QUANTITATIVE TIGHTENING

Monetary and fiscal policy are currently draining liquidity and materially increasing the amount of collateral in funding markets. For the second time following the Global Financial Crisis, the Federal Reserve is reducing the size of its balance sheet through QT.[1] With each dollar in assets that runs off the Federal Reserve's portfolio, private sector liquidity is also reduced. While current monetary policy withdraws liquidity, financing needs in the market continue to grow. Barring fiscal policy changes, the Treasury market is on track to grow from today's $28 trillion to over $50 trillion outstanding in the next decade.[2] (Figure 1) This would dramatically increase the amount of collateral that needs to be financed and put upward pressure on funding rates and term premia.

BANK REGULATORY CHANGES

Risk and regulatory changes have also made intermediation more complex, with bank and dealer intermediation capacity lagging the overall growth of the U.S. Treasury market. The March 2023 U.S. regional banking crisis also resulted in banks generally becoming more protective of cash reserves, with further regulation on the sector a possibility. One potential change includes pre-positioning collateral at the Federal Reserve's Discount Window to guard against liquidity shocks – which would pull collateral and liquidity from private markets. For the resilience of global financial markets, it is important that any future changes support intermediation and strengthen liquidity within the U.S. Treasury market.

[1] David Wessel, "How will the Federal Reserve decide when to end 'quantitative tightening'?" Brookings, October 17, 2024, https://www.brookings.edu/articles/how-will-the-federal-reserve-decide-when-to-end-quantitative-tightening/

[2] "Budget and Economic Data," Congressional Budget Office, https://www.cbo.gov/data/budget-economic-data#3

FIGURE 2:

CASH – PURCHASE & SALE

TRANSACTION TYPE	DAILY AVG. ($B)
ATS and Interdealer Broker	$376
Dealer to Customer	$354
TOTAL	**$730**

Prepared by BNY reflecting FINRA TRACE's Daily Aggregate Treasury Statistics for full year 2023.

FINANCING – REPO & REVERSE REPO

TRANSACTION TYPE	DAILY AVG. ($B)
Uncleared Bilateral	$2,177
Cleared Bilateral/GCF	$1,235
Triparty	$676
Other	$473
TOTAL	**$4,561**

Prepared by BNY reflecting New York Fed's Primary Dealer Statistics for full year 2023. Primary dealers do not typically participate in the ON RRP and are therefore not reflected.

MANDATED U.S. TREASURY CENTRAL CLEARING

The Treasury market is currently at an inflection point: liquidity is falling while demand for it is rising. In the absence of further action, higher price volatility, elevated longer-term yields and higher funding costs are possible. The market structure for government securities is being "reassembled" as regulators seek to enhance the safety of U.S. financial markets, most significantly through the SEC's mandate for central clearing of Treasury market transactions, which could require $4 trillion to be centrally cleared daily. (Figure 2)

The SEC rule will require market participants to submit a substantial portion of their cash and repo trades to clear at a U.S. Treasury central counterparty (CCP). The SEC rule aims to reduce counterparty settlement risk in stress scenarios and seeks to offer some balance sheet relief through netting of offsetting transactions. The rule will also require market participants to change the way they interface with the Treasury market. Importantly, this central clearing framework requires participants to post margin and make contingent liquidity commitments, which would increase the demand for liquidity in normal times and potentially during times of stress.

The implementation dates for the rule are approaching, with central clearing of eligible cash transactions required by December 31, 2025, and central clearing of eligible repo transactions required by June 30, 2026. Market participants can prepare by assessing whether their U.S. Treasury transactions are in scope for central clearing, determining the clearing access model that best fits their activity and implementing a robust change management program that considers the implications across risk, collateral management, technology, operations and legal.

IMPROVED LIQUIDITY AND COLLATERAL SOLUTIONS DRIVING RESILIENT GLOBAL MARKETS

The above structural changes underscore the importance of flexibility in sources and uses of funding. Market participants are seeking flexible and efficient liquidity solutions, including the ability to manage their liquidity in smaller time increments. The traditional overnight funding model is being complemented with more granular sources and uses of funding. Enter triparty intraday repo and early morning maturity triparty repo. Intraday triparty repo allows lenders to put their cash to work for a few hours during the day and for borrowers to receive secured funding for the needed period only. Early

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morning maturity triparty repo allows lenders to access their overnight triparty repo cash earlier in the day. While these products have existed in the bilateral repo and unsecured markets, the introduction of these products into the triparty repo space is an important step toward increasing the flexibility of vital money markets. Together, these options can help improve liquidity management.

While collateral can provide a much-needed source of liquidity for market participants, type, location and timing are critical factors that can help increase collateral mobility and utility. There have been significant industry advancements on all three of these fronts to allow for increased mobility, optimization and flexibility. As market participants seek more advanced collateral solutions, they need comprehensive answers that better enable them to meet their unique financing needs.

Due to the need to manage liquidity in varying time zones and jurisdictions, global collateral networks have continued to grow, connecting more markets. As a result, interoperable solutions have emerged, allowing market participants to mobilize collateral more efficiently to meet global funding requirements. These solutions are becoming increasingly advanced as they integrate new technologies, including distributed ledger technology, that allow them to mobilize assets across borders more efficiently.

Optimization, the process of managing and allocating collateral efficiently to meet liquidity needs, reducing costs and enhancing returns, is another key focus for market participants. As market participants seek to reduce their funding costs and needs, more sophisticated collateral optimization solutions provide a mechanism to manage regulatory requirements more efficiently across liquidity, funding and capital (e.g., Net Stable Funding Ratio, Liquidity Coverage Ratio). These solutions and algorithms have improved significantly, including by leveraging artificial intelligence.

With the potential for higher price volatility, elevated longer-term yields and higher funding costs on the horizon, market participants must stay nimble to navigate changes. Taking it one step further, these changes can be approached as strategic opportunities for growth. Increased partnership between the public and private sectors can not only help drive resilient and less fragmented global markets but can also establish key pathways to enable this growth.

Alex Cadmus, Laide Majiyagbe, Conor Sari and Nate Wuerffel contributed to this article.

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