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United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510–6075

November 3, 2022

The Honorable Jerome Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Chairman Powell,

I write to express my concern regarding increasing illiquidity in the market for U.S. Treasury securities. As the Board of Governors of the Federal Reserve System (the Fed) has observed, there has been a “notable deterioration in Treasury market liquidity” over the past year due to, among other things, less accommodative monetary policy associated with elevated inflation.[1] In recent weeks, several measures of market liquidity have reached their lowest levels since the onset of the pandemic in 2020.[2]

According to press reports, the Fed has discussed whether these market conditions—which its own policy choices helped to create—may prompt additional Fed intervention.[3] In addition, the Bank of England’s recent purchases of long-dated government bonds in response to market stress raise concerns that the Fed could take similar action if U.S. market conditions worsen.[4] I strongly urge you to resist such intervention, for at least two reasons. First, such action would undermine the Fed’s principal objective of fighting inflation, which continues to pose significant challenges for the U.S. economy. Second, it would repeat some of the mistakes of quantitative easing, such as obscuring the true cost and consequences of our mounting national debt.

The serious risks to financial stability posed by Treasury market illiquidity,[5] however, should force the Fed and other federal regulators to now consider potential solutions that do not involve further government intervention in the form of new bond purchases. Simply put, structural drivers of market

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[1] FED. RESERVE BD., FINANCIAL STABILITY REPORT 6 (May 2022), https://www.federalreserve.gov/publications/files/financial-stability-report-20220509.pdf.
[2] *See, e.g.,* Ethan Wu and Kate Duguid, *Fed’s faster ‘quantitative tightening’ adds to strain on bond market*, FINANCIAL TIMES (Sept. 14, 2022), https://www.ft.com/content/70e43592-30d0-4348-916b-673910ad7726 (“A measure of market depth calculated by JPMorgan that looks at two-, five-, 10- and 30-year Treasuries shows the worst liquidity since the spring of 2020. Bid-ask spreads – a measure of liquidity that captures the gap between buying and selling prices – have in recent months reached the widest levels since May 2020.”).
[3] *See* Jeanna Smialek, Jim Tankersley, and Joe Rennison, *After U.K. Market Blowout, American Officials Ask: Could It Happen Here?*, N.Y. TIMES (Oct. 19, 2022), https://www.nytimes.com/2022/10/19/business/economy/uk-united-states-markets.html.
[4] *See* Bank of England, News Release, *Bank of England announces gilt market operation* (Sept. 28, 2022), https://www.bankofengland.co.uk/news/2022/september/bank-of-england-announces-gilt-market-operation.
[5] *See, e.g.*, BOFA GLOBAL RESEARCH, LIQUID INSIGHT, TREASURY LIQUIDITY NEEDS STRONGER SOLUTIONS (Sept. 7, 2022), (asserting that declining liquidity and resiliency pose “one of the greatest threats to global financial stability today, potentially worse than the housing bubble of 2004-2007”).

illiquidity—*i.e.*, the significant increase in government debt since 2008 and the limited capacity of dealers to intermediate due to post-crisis capital regulations, among other things—require structural solutions. To that end, the Fed should pursue durable reforms that would enable the Treasury market to function smoothly during times of stress.

For example, the Fed should follow through with its commitment[6] to modify the supplementary leverage ratio (SLR). As the Group of Thirty, an independent group of leading economic and financial market thinkers, has rightly noted, "market-making in U.S. Treasury markets is a prime example of a low-risk activity to which banks have been allocating less capital since the SLR was put in place."[7] Because the SLR requires banks to maintain the same level of capital relative to *all* assets regardless of risk, it could discourage them from holding lower-yielding assets such as Treasuries and incentivize them to hold comparatively higher-yielding assets instead. To avoid further retrenchment from Treasury market-making by bank-affiliated dealers, the Group of Thirty recommended changes to "ensure that the SLR functions as a backstop rather than a constraint that binds frequently."[8]

In addition, the Fed should assess the advantages and drawbacks of a greater portion of the Treasury market moving to "all-to-all" trading (*i.e.*, trading platforms that would enable any market participant to trade directly with any other market participant). Some global regulators have recently said all-to-all trading "could encourage a more diverse set of participants, including new players that can potentially complement traditional dealers in their liquidity provision activities."[9] It appears that the Federal Reserve Bank of New York has already started to research the opportunities and challenges presented by all-to-all trading of Treasuries,[10] and I urge you to study this work and carefully consider stakeholder feedback about all-to-all trading before market dysfunction reemerges.

In parallel with these medium- to long-term reforms, the Fed should take steps as soon as possible to improve Treasury market functioning and minimize the chance of disruption. For example, consistent with bank liquidity regulations, the Fed should ensure that examiners treat Treasuries and reserves equivalently for purposes of banks' internal liquidity stress tests.[11]

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[6] *See* Fed. Reserve Bd., *Federal Reserve Board announces that the temporary change to its supplementary leverage ratio (SLR) for bank holding companies will expire as scheduled on March 31* (Mar. 19, 2021), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210319a.htm.
[7] GROUP OF THIRTY, U.S. TREASURY MARKETS: STEPS TOWARD INCREASED RESILIENCE 15 (July 2021), https://group30.org/images/uploads/publications/G30_U.S_._Treasury_Markets-_Steps_Toward_Increased_Resilience__1.pdf.
[8] *Id.*
[9] FIN. STABILITY BD., LIQUIDITY IN CORE GOVERNMENT BOND MARKETS 29 (Oct. 20, 2022), https://www.fsb.org/wp-content/uploads/P201022.pdf.
[10] *See* FED. RESERVE BANK OF NEW YORK, ALL-TO-ALL TRADING IN THE U.S. TREASURY MARKET (Oct. 2022), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr1036.pdf.
[11] *See, e.g.*, David Andolfatto and Jane E. Ihrig, *The Fed and a Standing Repo Facility: A Follow-Up*, FED. RESERVE BANK OF ST. LOUIS (Apr. 19, 2019), https://www.stlouisfed.org/on-the-economy/2019/april/fed-standing-repo-facility-follow-up ("While U.S. Treasuries are given equal weight with reserves in the calculation of high-quality liquid assets (HQLA) for the [Liquidity Coverage Ratio], they are evidently not considered equivalent for resolution purposes. Internal liquidity stress tests apparently assume a significant discount on Treasury securities liquidated in large volumes during times of stress, so that Treasuries are not treated as cash-equivalent. We have heard that banks occasionally feel under supervisory pressure to satisfy their HQLA requirements with reserves rather than Treasuries.").

To better understand how the Fed is approaching Treasury market reform, please provide written responses to the following questions by November 17, 2022:

1. Does the Fed agree that the SLR and other capital rules could inhibit market-making in Treasuries by bank-affiliated dealers? If so, is the Fed currently considering how to modify the SLR so that it functions as a backstop rather than a binding capital constraint?

2. Has the Fed analyzed the merits of all-to-all trading for a greater portion of the Treasury market? If so, what insights has such analysis yielded?

3. Is the Fed exploring any other reforms to improve Treasury market liquidity? If so, please describe the nature of those reforms, including whether any regulatory changes would be necessary in order to implement them.

4. How does the Fed distinguish between market dysfunction that necessitates bond purchases and acceptable market volatility? Are there specific quantitative or qualitative measures that the Fed weighs heavily? Do you agree that financial market volatility can sometimes be a sign of a functioning market, reflecting the process of price discovery for the market price of risk?

Thank you for your attention to this matter.

Sincerely,

Pat Toomey
Ranking Member

cc: The Honorable Lael Brainard, Vice Chair, Board of Governors of the Federal Reserve System
The Honorable Michael S. Barr, Vice Chair for Supervision, Board of Governors of the Federal Reserve System
The Honorable Michelle W. Bowman, Governor, Board of Governors of the Federal Reserve System
The Honorable Lisa D. Cook, Governor, Board of Governors of the Federal Reserve System
The Honorable Philip N. Jefferson, Governor, Board of Governors of the Federal Reserve System
The Honorable Christopher J. Waller, Governor, Board of Governors of the Federal Reserve System