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Internalization is not what makes the Treasury market opaque

October 15, 2015

The anniversary of the Treasury "flash crash" and next week's market structure meeting at the NY Fed has brought with it a renewed focus on the functioning of the US Treasury trading. In an effort to provider further clarity into how this market works today and how it might work in the future, we published a report earlier this week based on over 100 interviews with investors, dealers and principal trading firms.

We concluded among other things that the lack of transparency (aka data) surrounding US Treasury trading is surprising given the importance of the market. While we firmly believe this to be true, the reason why appears to be somewhat misunderstood.

Internalization, the practice of dealers to cross opposing orders internally rather than exposing them to the open market, is not the cause of this opacity. Internalization, which is common in every liquidity OTC market, is used not to "hide" orders but instead to reduce fees and market impacts for both sides of the trade. In many cases this approach can provide clients with meaningful cost savings. For Treasuries, this can prove particularly true for off- the-runs that are traded less frequently and therefore have a great market impact when they are.

It goes without saying that if all orders were internalized market liquidity would be impacted (are you starting to think about equity markets all of a sudden?). But that is neither possible nor likely given the size of the US Treasury market and the diversity of its participants. So for now, think of internalization as a value added service dealers provide to their customers.

The full passage from our recently released report on US Treasury trading market structure explains our true concerns with the market:

> "*While the market has grown to trade in a heavily electronic way with very little regulatory intervention, the level of opacity that still exists in the market for the debt issued by the largest economy in the world is stunning. There is no required trade reporting, no required participant registrations, an exemption from the Volcker Rule, and no single body that is responsible for ensuring the market remains controlled and orderly.*
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> *Greenwich Associates does not believe all of those things need to change. In fact, allowing natural market forces to drive appropriate change is often preferable to regulatory intervention. The year that has passed since the U.S. Treasury "flash crash" on October 15, 2014 now has seen an industry interested in taking the former approach.*"

Comments, questions and opinions always welcome.

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