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Investment Grade Fixed Income

No relief from the Supplementary Leverage Ratio (yet)

Picture of

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Boston - The supplementary leverage ratio, or SLR, is one of the leverage tests for U.S. banks that regulators implemented in response to the global financial crisis from 2007 to 2008. Last May, after several months of eye-watering volatility in the Treasury market — and with bank reserves skyrocketing due to QE purchases — the Fed granted a temporary exemption from the SLR calculation for reserves and Treasurys. Last Friday, the Fed decided to let the exemption expire at the end of March as planned.

Motivation for the SLR exemption

The SLR is a relatively simple test that limits the size of a bank's assets relative to its capital base, requiring banks to set aside capital for even the safest of financial assets, such as Treasurys and bank reserves. By temporarily exempting banks from the SLR on May 15, 2020, the Fed allowed them to expand their balance sheets to accommodate more reserves and government debt, while also improving liquidity in the Treasury market. The exemption was set to expire on March 31, 2021.

Expected to be extended

Fast forward to today, and the market could be forgiven for expecting the SLR exemption to be extended. After all, excess reserves are nearly double what they were pre-pandemic, and the Treasury market is coming off one of the most volatile months in recent history. Additionally, with a fresh $1.9 trillion stimulus package coming out of Washington, there will be plenty of Treasury issuance that needs to be financed.

If the Fed let the exemption expire, so the thinking went, the banks —who were the second biggest buyers of Treasurys after the Fed last year —would rush to sell their holdings. That could pour fuel on the fire of an already wrenching bear market for bonds.

Reaction to the exemption expiration

Despite all the handwringing, Treasury yields popped a modest three basis points on Friday's announcement, before quickly regaining their losses. The reason for the muted market reaction is likely two fold.

First, it seems that banks had decided not to wait around for the Fed to make up its mind. According to data released on March 18, primary dealers sold over $80 billion in Treasurys in the two weeks ended March 10, which was the largest two-week sale on record going back to 1997.

Second, the Fed also announced that it would launch a formal review of the SLR, suggesting that banks may be granted permanent capital relief for reserves and Treasurys at some point.

Concern about reserves

While the focus of the SLR drama has primarily been the Treasury market, we suspect the Fed is probably much more concerned about reserves. Excess reserves have doubled since last year and are set to double again to over $5 trillion by mid-2022 as a result of continued QE and the drawdown of unspent proceeds from Treasury issuance in 2020.

Without regulatory relief, reserves could become an increasingly costly asset for banks to hold. There are already anecdotes about banks charging for new deposits or flat out turning them away. In an adverse scenario, the aversion to hold reserves could impede money markets, push Treasury bill yields below zero and cause banks to pull back on lending.

This concern could be one reason why on March 17, the Fed announced it was lifting caps on its reverse repo facility from $30 billion to $80 billion per counterparty. That would make it easier for reserves to be drained from the system should they become too much of a burden on banks. With a formal review of the SLR, the Fed seems to be eying a permanent fix for the reserve issue, which would allow QE to continue unimpeded.

Bottom line: In our view, ending the SLR relief may only be a temporary hiccup for the Treasury market. A permanent fix for the SLR would lower yields, foster liquidity and allow the smooth implementation of future QE programs.

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