

Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

The views expressed in these posts are those of the authors and are current only through the date stated. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance strategy. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness.

MARCH 22, 2021

Investment Grade Fixed Income

No relief from the Supplementary Leverage Ratio (yet)

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 Treasuries. 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 Treasuries 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 Treasuries 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 Treasuries 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 Treasuries at some point.

Picture
of

Brian Shaw
Portfolio Manager
Eaton Vance
Management

"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."

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 eyeing 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.

All investing involves risk, including the risk of loss.

An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline.

[Accessibility](#) | [Privacy & Security](#) | [Terms & Conditions](#) | [Form CRS](#) | [Contact](#)

Eaton Vance is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley

The information on this Web site is for U.S. residents only. The information on this Web site does not constitute an offer to sell, or a solicitation of an offer to purchase, securities in any jurisdiction to any person to whom it is not lawful to make such an offer.

There are no guarantees regarding the achievement of investment objectives, target returns, portfolio construction, allocations or measurements such as alpha, tracking error, stock weightings and other information ratios. The views and strategies described may not be suitable for all investors. Not all of Eaton Vance's recommendations have been or will be profitable. Eaton Vance does not provide tax or legal advice. Investing entails risks and there can be no assurance that Eaton Vance (and its brands) will achieve profits or avoid incurring losses. Prospective investors should consult with a tax or legal advisor before making any investment decision.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

© Eaton Vance Management. All rights reserved. Two International Place, Boston, MA 02110