US Rates Strategy

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SLR relief and repo activity

The Fed and other bank regulators have released a SLR relief proposal for public comment. Much of the market's focus has been on the net incremental bank demand for Treasuries. But we think an equally important question is the extent GSIBs can expand their intermediation capacity to support secondary market liquidity.

- Regulators have proposed reducing the capital buffer from the current 2% to 50% of the capital required under the banks' Method 1 systemic risk score.
- The Fed estimates that at the holding company level, the GSIBs could potentially increase their Treasury holdings by $2.1trn. But this estimate is overstated once hedging effects and Tier 1 risk-based capital requirements are considered.
- **Past research suggests repo activity is 3-5 times more sensitive to SLR constraints than the GSIB banks' holdings of Treasuries**. Freeing up balance sheet could encourage more GSIB repo volume.
- **But the value of SLR relief may have declined since the exemption period with the expansion in centrally cleared repo volumes**.
- As a result, SLR relief may matter more for certain types of repo activity (specifically those trades that cannot be cleared easily).
- It may also make it easier for banks to temporarily expand their balance sheets in response to a sudden or unexpected increase in funding demand.

Changing the SLR

The supplemental leverage ratio (SLR) requires banks to hold capital against all their exposures regardless of these holdings' relative riskiness. A dollar's worth of cash held as bank reserves has the same (leverage) capital requirement as a similar amount of consumer loans. **This makes high volume-low risk activities like making markets in repo and off-the-run Treasuries expensive.** The SLR has been blamed for the seizing up of market liquidity during the March 2020 "dash for cash" as well as other episodes where the ability of banks to temporarily expand their balance sheets has been constrained.[1] The leverage ratio has also been criticized since it may encourage banks to substitute riskier assets for holdings of cash and Treasuries.[2]

Because of the unintended Treasury market liquidity effects, reforming the SLR has been a key focus of markets, banks, and academics since its introduction nearly ten years ago. Indeed, the Fed was concerned enough about these effects that it temporarily exempted banks' holdings of Treasuries and cash (reserves) from the SLR calculation during QE. As a result, the Fed was able to increase the level

[1] See, for example, "Recent Disruptions and Potential Reforms in the US Treasury Market: A Staff Progress Report", US Treasury, Federal Reserve Board, Federal Reserve Bank of New York, SEC, CFTC, November 8, 2021.
[2] As we discuss below, this marginal effect is mitigated by the bank's Tier 1 risk-weighted capital requirements.

of bank reserves by $2trn without overwhelming bank capital requirements (Figure 1). But, it allowed the temporary exemption to expire at the end of March 2021. And while analysts and academics have continued to research SLR-related liquidity effects ever since, the Fed has left the leverage ratio calculation unchanged. Regulators have instead turned to other ways to expand bank intermediation capacity that do not require changing capital requirements. In 2023, the SEC mandated centrally clearing certain types of cash Treasury trades and effectively all Treasury repo by mid-2027. And, separately, the Treasury later adopted buybacks for its off-the-run issues.

Last fall, and ahead of publishing final Basel III rules, bank regulators began examining capital rules and the leverage ratio. Although Basel III rulemaking has been postponed pending review, regulators have moved quickly to address the leverage ratio. **Last month, the Fed released a proposal that would lower large US GSIB banks' capital requirements. It shifts the SLR calculation from a flat 2% to one-half of the GSIB's method 1 capital surcharge.**[3] The proposal shifts the capital relief toward the depository institution subsidiary of the holding company.

Implications

Markets have focused on the potential incremental bank demand for Treasuries. **The Fed estimated that relative to the existing rule, the SLR change could potentially increase the GSIBs' capacity to hold Treasuries by $2.1trn**. Because these holdings have zero-risk weights, banks could, in theory, fully allocate all the capital released from the SLR change to expand their Treasury holdings by this amount.

However, this assumes these holdings are fully hedged. As the Fed notes, this is somewhat unrealistic given the nature of banks' intermediation activities which leave them either net long or short. Similarly, in repo, the dealer arms of the GSIB banks are traditionally net cash lenders (i.e., their reverses are greater than their repos). Unhedged activity adds to banks' risk weightings and thus their Tier 1 capital requirements. And, mechanically, balance sheet expansion increases banks' capital requirements under their Method 1 GSIB systemic risk score (through the size subcomponent). The net effect, according to the Fed, is "meaningfully" smaller than $2.1trn.

Separately, balance sheet relief from the SLR change is concentrated at the depository institution level rather than the overall holding company. The Fed estimated that the rule change might reduce Tier 1 capital requirements at the depository level by 27% across all the GSIBs. However, the reduction is far smaller (just 2%) at the holding company level. GSIB intermediation is done through their (primary) dealer subsidiaries rather than their deposit-taking arms. As a result, any increase in trading volumes depends on banks' ability (and willingness) to shift capital between the bank and dealer arms of the holding company.

Higher repo trading volumes?

That said, past studies based on the exemption period have found evidence of an increase in Treasury trading although the effects seem small and concentrated in repo. Our sense is that this reflects the fact that repo is a low margin-high volume business that "consumes" more dealer balance sheet their Treasury holdings. Repo volumes are also more sensitive changes in the demand for liquidity and funding; especially in periods of market stress like the March 2020 "dash for cash". During the "dash for cash"

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[3] Large banks hold a capital buffer tied to the systemic risk they represent for financial markets. In addition to its size, this risk metric includes the effects of its interconnectedness, cross-jurisdictional activities, complexity, as well how easy it is to find substitutes for the services the bank provides. The method 2 framework replaces the substitutability component of the method 1 score for a measure of the bank's reliance on short-term wholesale funding.

banks suddenly experienced a sharp expansion in their overall balance sheet sizes as their customers drew on credit lines in order to stock up on cash ahead of the economic shutdown. Favara et al. found that during this period, bank balance sheet constraints had a 5-times larger effect on repo activity than on their overall Treasury holdings.[4] Cochran et al. find similar effects which is not surprising as banks' repo activity accounts for 6% of GSIBs' total leverage exposures compared to the 2% of their Treasury holdings.[5]

Nevertheless, the scale of these volume effects for repo does not seem very large. It is difficult to see much of a volume increase in repo trading during the exemption period. Likewise, volumes did not decline once the exemption expired. Similarly, Koont and Walz note that banks that benefited the most from the Treasury and cash exemption – that is, those that were closest to their capital constraint in Q4 2019 did not grow larger or faster than other banks although they find evidence that repo intermediation increased.[6] We suspect the somewhat unimpressive effect on repo volumes may reflect a couple of factors specific to the treatment of Treasury repo during the exemption period as well as weak demand for secured funding. Similarly, banks and dealers may have recognized the temporary nature of the exemption and decided not to shift capital across their subsidiaries. Together these effects suggest the history of the exemption period may be different from the current SLR proposal.

Our sense, is that the SLR change may unlock *some* increase in GSIB repo trading although it probably matters more in periods when markets are under stress. Untapped capital relief could make it easier for banks to "flex" their repo balance sheets; temporarily increasing trading volumes to accommodate a sudden or unexpected increase in the demand for financing. But even this might be disappointingly small.

Less important

The value of SLR relief may have declined since the exemption period as centrally cleared repo activity has increased. Clearing allows FICC members to net their repo longs and shorts as each trade faces the same counterparty.[7] Netting allows banks to preserve balance sheet capacity since the same dollar of capital can support a higher volume of transactions. Moreover, it is less work for dealers as they have less need to engineer offsetting transactions or package trades bilaterally with their counterparties. Instead, they can sponsor their client's activity onto the platform and net the transactions off against their other repo activity. Not surprisingly, sponsored repo volumes (reverses and repos) have increased 5-fold since 2020 (Figure 2).

But even with the availability of central clearing almost 60% of primary dealers' repo (and reverse) activity is uncleared amounting to roughly $2.5trn. We suspect this reflects several influences including the margin costs applied to centrally cleared transactions as well as the time it takes to sign up clients to participate in sponsored repo. But it also reflects the fact that some types of repo transactions are not easy to centrally clear. These include on-open or repo trades that are rolled from day-to-day and have no fixed maturity date as well as term transactions. Bowman et al. observe that roughly 20% of GSIBs' tri-party and non-centrally cleared bilateral repo (NCCB) trades have no fixed maturity date and,

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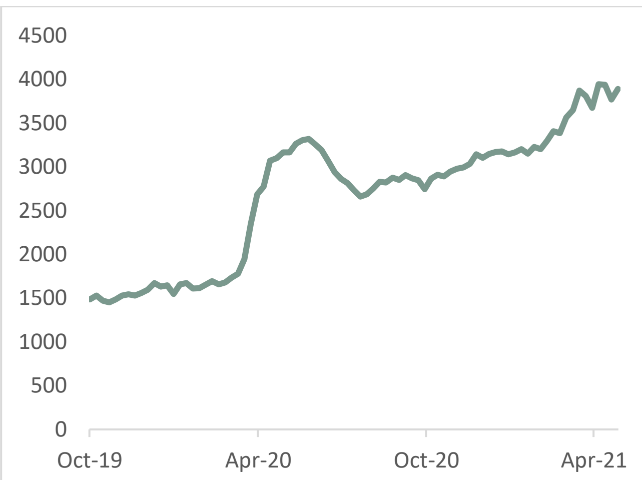
[4] See, "Leverage Regulations and Treasury Market Participation: Evidence from Credit Line Drawdowns", G. Favara, S. Infante, and M. Rezende, Federal Reserve Board, December 14, 2022.
[5] See, "Dealers' Treasury Market Intermediation and the Supplemental Leverage Ratio", P. Cochran, S. Infante, L. Petrasek, Z. Saravay, and M. Tan, Federal Reserve Board, August 3, 2023.
[6] See, "Bank Credit Provision and Leverage Constraints: Evidence from the Supplementary Leverage Ratio", N. Koont and S. Walz, Columbia Business School, July 2021.
[7] There are other benefits to clearing including a standardization of member activity, haircuts, and position monitoring.

significantly, the volume of these transactions has grown in the last five years to reach a few hundred billion dollars.[8]

Nearly all tri-party activity is overnight reflecting its primary use as a financing instrument for dealers. Centrally cleared trades are also heavily skewed toward overnight maturities. **But over half of NCCB activity has terms longer than overnight**. As the maturities on these transactions reflect the needs of the borrowers (lenders) they tend to be fairly bespoke transactions. Typically, dealers structure these transactions as packages for their client with both a repo and reverse repo leg to the same maturity date. This reduces their balance sheet consumption through Fin 41 netting. That said, nearly half of primary dealers' NCCB activity was outside of these package structures.

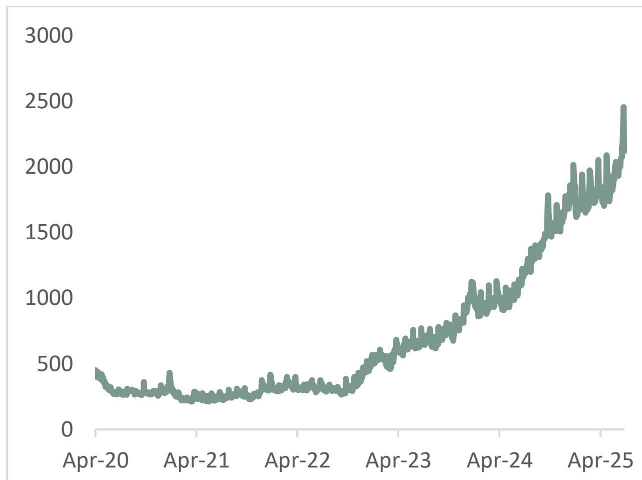
Our sense is that SLR relief may matter more for repo activity than GSIBs' Treasury holdings. But even for repo, the relief may matter more for certain *types* of repo transactions. And, this may be most important in periods of strain when GSIBs need to temporarily flex their repo capacity to accommodate strong funding demand.

Figure 1: Bank reserves ($bn)



Source: Source: Federal Reserve, SMBC Nikko

Figure 2: Sponsored repo volume ($bn)



Source: DTCC, SMBC Nikko

[8] See, "Balance Sheet Netting in the US Treasury Markets and Central Clearing", D. Bowman, Y. Huh, S. Infante, Federal Reserve Board of Governors, June 2024.

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