Financial Services Management

SLR Relief

Cite
FRB, OCC, FDIC; Interim Final Rule (IFR); Regulatory Capital Rule: Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio for Depository Institutions

Recommended Distribution:
CFO, Asset/Liability Management, Capital Management, Policy, Legal, Government Relations

Websites:
https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200515a1.pdf

Impact Assessment

- Affected banks may gain $1.2 trillion in leverage capacity. The agencies expect this to result in significant added financial intermediation and resulting market support.
- The nature of exempted assets and the risk-based capital framework make it likely that added leverage capacity will support wholesale finance and provide buffers for additional loan-loss provisioning rather than increase retail-credit availability.
- The capital-distribution constraints could adversely affect market capitalization or even shock investors, but the agencies hold open the prospect that at least dividends could continue even if other distributions are blocked. The Fed may elect a different approach to capital-distribution constraints or persuade the other agencies to reduce obstacles to them in concert with SLR relief.
- The final rule could exempt other assets, providing added relief that could increase international lending and/or mortgages backed by Ginnie Mae.

Overview

Following the Federal Reserve's decision to provide temporary supplementary leverage ratio (SLR) relief for large bank holding companies,[1] all of the federal banking agencies have done the same for insured depository institutions (IDIs), providing even greater relief for GSIBs subject to the enhanced supplementary

[1] See **LEVERAGE22**, *Financial Services Management*, April 6, 2020.

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leverage ratio (eSLR) set at six percent for IDIs.[2] Under the IFR, reserves held at the Fed and direct Treasury obligations do not count in the SLR denominator, significant relief given that these assets are already exempt from any risk-based capital charge.[3] However, unlike the FRB's rule for BHCs, the IDI standards are voluntary and conditional, exposing IDIs that elect relief to a ban on at least some capital distributions. If IDIs nonetheless elect SLR relief, leverage capacity will increase significantly, combining with that afforded at the BHC level to provide almost ten percent more balance-sheet capacity for additional activities and/or risk recognition.

Impact

As recognized earlier in the FRB's SLR relief for large BHCs, the COVID crisis has led to large deposit inflows that many banking organizations are housing in Federal Reserve excess reserves and Treasury obligations. At the same time, many large borrowers have drawn down credit lines and banks are also participating in numerous Fed facilities. Some of these have received capital "neutralization,"[4] but not all have been exempted and, in any case, balance-sheet growth has been so large so fast that many banks are coming close to minimum capital ratios. Earlier standards making it clear that buffers could be depleted have helped somewhat,[5] but the agencies remain fearful that capital thresholds may be crossed and, if they are, that banks will then withdraw from activities essential to sustaining the U.S. financial system.

As revised by the final tailoring rules,[6] U.S. GSIBs and banking organizations subject to Category II or III standards now come under the SLR, a three percent or higher charge covering both on- and off-balance sheet assets.[7] In addition, these companies, like all other U.S. banking organizations are covered by a Tier 1 leverage ratio set by the Collins Amendment to the Dodd-Frank Act as at least three percent of on-balance sheet assets.[8] Because this leverage ratio (LR) is set by law, this IFR does not remove it. As a result, central-bank deposits and Treasury obligations still come under a LR when held on a company's balance sheet.

This mandatory LR has become an increasingly binding constraint on large banks as deposit flows continue, leading the FRB to call on Congress to relax it during the national emergency. So far, no substantive efforts to do so have advanced. Thus, sweeping though this relief is, it does not entirely exempt covered assets from the SLR. Even so, its reach is significant, estimated to increase leverage capacity by over $1 trillion if all eligible IDIs elect the exemption.

Because this IFR governs only IDI capital, it does not affect a BHC's overall ability to distribute capital as expanded by the Fed's SLR-relief standard. BHC

[2] See **LEVERAGE6**, *Financial Services Management*, April 14, 2014.
[3] See **CAPITAL200**, *Financial Services Management*, June 23, 2011.
[4] See **COVID7**, *Financial Services Management*, March 23, 2020.
[5] See **COVID7**, *Financial Services Management*, March 23, 2020.
[6] See **SIFI34**, *Financial Services Management*, October 23, 2019.
[7] See **LEVERAGE8**, *Financial Services Management*, October 7, 2014.
[8] See **CAPITAL177**, *Financial Services Management*, June 23, 2011.

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capital distributions are principally governed by stress testing, with the FRB now planning to revise the current CCAR round to cover COVID's effect.[9] SLR relief may well buffer any COVID-related concerns, especially if the FRB believes that the IDI's primary regulator will allow the bank to upstream capital to the parent company.

As noted, SLR relief is not automatic. IDIs will thus need carefully to weigh its benefits versus the adverse market reaction to any regulatory decision to suspend capital distributions to the BHC. Even if the BHC maintains distributions at expected levels – which is unlikely at all BHCs with large lead banks – the sudden disappearance of or even reduction in dividends or, where these have continued, of stock buy-backs could shock investors and adversely affect market capitalization. BHCs experiencing a sudden loss of market confidence are likely to reduce financial intermediation, adversely affecting the agency's goals. A blanket ban on distributions might prevent market dislocations for individual institutions but not necessarily enhance leverage capacity if overall market capitalization drops in response to investor disappointment about prospective distributions.

Perhaps reflecting the market-capitalization benefits of BHC capital distributions and resulting BHC resiliency under stress, the FRB seems unwilling to impose the strict prior-approval criterion in the IFR, instead suggesting only prior notice and perhaps even a system in which IDIs could elect the SLR exemption at any time during the IFR's pendency in which the bank believed its leverage capacity was running low. Opponents of this approach counter that investors will respond more negatively to unexpected and sudden capital-distribution restrictions than to prior election, especially if most large IDIs make use of the SLR exemption.

Because of the limited assets covered by the BHC and IDI exemptions, the most immediate effect of the rules is to allow banking organizations to hold more of the assets that count as "high-quality" under liquidity rules without adverse capital consequence.[10] Although this intermediation might include lending beyond meeting ongoing demands related to credit-line draws, it seems likely that most banks will be reluctant to use leverage capacity to take on new risk in the midst of ongoing economic disruptions and resulting loan forbearance, forgiveness, and reserving. However, additional capacity might result if the class of exempted assets is expanded following comments on questions in this IFR and identical ones posed by the FRB. For example, if exemptions expand to assets guaranteed by the U.S. Government, then banks might be willing to make more Ginnie Mae insured mortgages, shifting portfolio concentrations from Fannie and Freddie to the U.S. full-faith-and-credit mortgage guarantor. Expanded financing for emerging or other sovereign markets is also possible if exemptions expand to other sovereign issuers, although it is likely that the agencies would limit any exemption to low-risk issuers as is now the case in the U.S. capital framework.

[9] See *Client Report* **COVID11**, May 12, 2020.

[10] See **LIQUIDITY17**, Financial Services Management, October 1, 2014.

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What's Next

The IFR was released on May 18. It is effective on *Federal Register* publication but will govern third-quarter capital distributions. Revised SLRs may be reported based on June 30 totals as if the IFR had been in effect throughout the second quarter, maximizing the rule's impact. Comments are due 45 days after publication, with the exemption expiring on March 31, 2021. Conforming changes to reporting requirements will follow shortly.

Although supported by FRB Gov. Brainard – a frequent opponent of LR relief – FDIC Director Gruenberg opposed the rule on grounds that it was over-expansive and provided too much scope for capital distributions. Changes to the final rule could heighten opposition to it, but final approval nonetheless seems likely, especially given that the IFR's timing brings it into effect before the agencies bring a final version of the rule before the Federal Reserve or FDIC boards.

Analysis

A. Capital Relief

As noted, this IFR exempts Federal Reserve deposits and Treasury obligations from the SLR denominator until March 31, 2021. As noted, this relief is voluntary. IDIs that opt for it will need prior approval for capital distributions from their primary federal regulator, doing so within thirty days of the IFR's effective date. Case-by-case requests in conjunction with subsequent decisions to make use of this capital relief are possible, with the IFR detailing how approvals are to be sought and considered by the agencies. Even if some capital distributions are barred, the IFR suggests that dividends may still be allowed. Factors to be considered for capital-distribution approval include:

- current earnings and forecast;
- the nature of the request; and
- the circumstances giving rise to it.

Any other limits on capital distributions continue to apply.

B. Request for Comment

All of the agencies seek views on:

- implications for financial intermediation and safety and soundness;
- the need for an earlier or later end to temporary relief;
- the benefits of adding additional assets or exposures to the exemption. Options noted include foreign central-bank deposits, foreign sovereign debt, or exposures guaranteed by the federal government; and
- the need also to exclude certain repo transactions.

The Fed on its own also seeks views on:

- allowing state member banks more than thirty days to make the decision about seeking this exemption, perhaps allowing them to do so at any time;

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- the benefits of a prior-notice rather than prior-approval requirement for capital distributions; and
- a different approach to capital-distribution constraints, e.g., requiring prior approval or notice only if distributions are above prior levels.

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