If the Treasury Issues Debt and the Fed Buys It, Should Bank Capital Requirements Go Up?

Greg Baer and Bill Nelson | March 8, 2020

Over the next year, in order to fund higher spending, the Treasury Department is expected to issue about three trillion dollars in debt. As part of its plan to support the economy and the Treasury market through asset purchases, the Federal Reserve is expected to purchase much of that debt. One might quite reasonably assume that their actions would have no effects on bank capital requirements, but that assumption currently would be wrong.

Many believe that when the Federal Reserve buys a Treasury, the security is cancelled. But the Treasury remains outstanding (details here). Instead, the Treasury moves onto the Fed's balance sheet as an asset. Because the Fed's balance sheet must balance, a liability must be created, and that liability takes the form of bank reserves. So, if the Fed buys $1 trillion in Treasuries (as seems likely), bank reserves will be increased by $1 trillion.

Reserves are not only a liability of the Fed but also an asset of banks. Of course, risk-based capital requirements recognize that a reserve (digital cash) at the Fed is risk-less and could not be more liquid, so there is no reason to require a bank to hold more capital when the Fed increases reserves. But a leverage ratio treats all assets the same — so cash at the Fed carries the same effective 100 percent risk weight as a subprime mortgage.

Thus, the counterintuitive (to put it mildly) result of the Treasury issuing debt and the Fed buying it is to increase capital requirements on banks subject to a leverage ratio. Banks then must either raise capital (even though they are already well above their risk-based capital requirements and buffers) or decrease other assets, with most of their other assets taking the form of loans. Presumably, they will do some of both.The largest banks, which are also securities dealers, might choose to not reduce loans but rather shed lower-yielding assets more akin to reserves — namely Treasuries and short-term, collateralized loans to investors to fund their own Treasury holdings. (These Treasuries and repo also come with a 100 percent leverage capital requirement, like a subprime mortgage.) But a main reason the Fed is buying Treasuries is to support the Treasury market. So, presumably and perversely, the Fed would need to buy still more Treasuries as the leverage ratio pushed banks to shed them and the Treasury market becomes less liquid still.

Of course all this is likely why the Federal Reserve, which wants to encourage economic growth and market functioning, is reportedly considering some permanent modification to the leverage ratio at the holding company level. Given the potential impact on Treasury markets, one might hope that the Treasury Department would feel the same, and because relief is also necessary at the bank level, where reserves are held, the OCC (a Treasury bureau) might be expected to follow suit. (To date, the OCC has taken the position that any bank seeking such relief must cede its dividend authority to the regulator; not surprisingly, this option has attracted few takers, as it adds uncertainty to potential dilution as a concern for investors.)

And those opposing reform need to answer a hard question, "Why should the Treasury issuing a bond and the Fed buying a Treasury raise banks' capital requirements (or newly empower regulators to set bank dividends)?"

____

Disclaimer: The views expressed do not necessarily reflect those of the Bank Policy Institute's member banks, and are not intended to be, and should not be construed as, legal advice of any kind.