

# Regulators Need To Revisit the Calibration of Leverage Ratios

Francisco Covas and Anna Harrington | Mar. 3, 2021

When the Federal Reserve Board approved the original 2 percent flat enhanced supplementary leverage ratio (eSLR) buffer applicable to the U.S. global systemically important banks (GSIBs) at an open meeting on April 8, 2014, several Board members expressed concern about the unintended consequences of a binding leverage ratio. Namely, a binding leverage ratio reduces the demand for safe assets and makes banks less willing to provide liquidity to U.S. Treasury markets. Staff noted that the impact of the eSLR on bank balance sheets would likely be modest in part because “the level of reserve balances will be lower in the future as the size of the Federal Reserve’s balance sheet is reduced...”<sup>1</sup>. That is, at that time Fed staff was expecting a reduction in reserve balances which would help make the leverage ratio more of a backstop to risk-based requirements.

However, the decline in reserve balances did not materialize as expected when the eSLR rule was adopted. In April 2014, reserve balances were at \$2.6 trillion and expected to decline considerably by the time the eSLR become effective in 2018 (expected to be about \$1.3 trillion in 2018 according to the [March 2014 Tealbook B](#), p.48 and projected to fall to \$25 billion by 2021). However, reserve balances were still at \$1.4 trillion in September of 2019 just as we observed significant volatility in money market rates driven by the scarcity of reserve balances. Subsequently, reserve balances rose to \$1.7 trillion and stayed roughly at that level until the onset of the COVID event. Following the Federal Reserve’s massive interventions necessary to help stabilize Treasury markets in March 2020, and the Federal Reserve’s ongoing large-scale asset purchases, reserve balances are now twice as large as they were at the onset of COVID (nearly \$3.4 trillion) and are projected to surpass \$5 trillion by the end of 2021.<sup>2</sup>

The Federal Reserve took action in April 2020 to temporarily exclude reserve balances and U.S. Treasury securities from the denominator of the supplementary leverage ratio.<sup>3</sup> The exclusion encouraged banks to increase low-risk, balance-sheet-intensive activities, such as making markets in Treasuries or providing repo financing to others to support trading in Treasuries. Indeed, banks’ holdings of Treasuries and agency MBS increased nearly \$670 billion or about 41 percent over the course of 2020. During the same period reserve balances held by those banks increased from \$530 billion to \$1,141 billion. To continue to provide liquidity to markets, the Federal Reserve should consider extending the exclusion for reserve balances and U.S. Treasury securities from the SLR denominator. This extension would mitigate the effect of the Federal Reserve’s balance sheet growth on intermediation by bank holding companies. Further, the extension should last until the banking agencies agree on a long-term solution to make leverage capital requirements once again a backstop to risk-based requirements.<sup>4</sup>

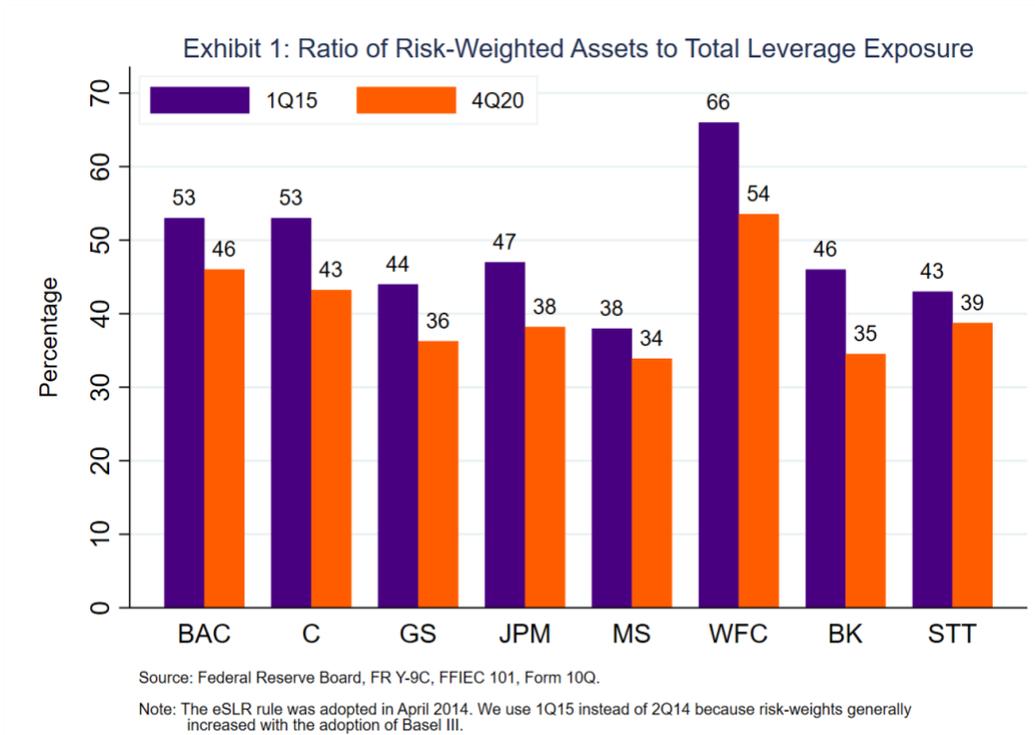
<sup>1</sup> Federal Reserve Board, Transcript of Open Board Meeting at 8 at 15 (Apr. 8, 2014), <https://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20140409.pdf>.

<sup>2</sup> The FOMC has stated that it will keep expanding its holdings of Treasury securities and agency MBS at their current monthly paces of \$80 billion and \$40 billion, respectively, until they have made “substantial further progress” toward *both* their objectives: 2-percent average inflation and maximum employment. Moreover, the Treasury General Account at the Fed is currently at a record \$1.6 trillion and is expected to decline substantially over the coming months, perhaps to \$500 billion.

<sup>3</sup> See 85 Fed. Reg. 20,578 (Apr. 14, 2020). Similar actions at the bank level proved to be elusive due to a dividend approval condition; only two banks opted in. See 85 Fed. Reg. 32,980 (June 1, 2020).

<sup>4</sup> See, e.g., 83 Fed. Reg. 17,317, 17,319 (Apr. 19, 2018) (“Leverage capital requirements should generally act as a backstop to the risk-based requirements. If a leverage ratio is calibrated at a level that makes it generally a binding constraint through the economic and credit cycle, it can create incentives for firms to reduce participation in or increase costs for low-risk, low-return businesses.”); see also Federal Reserve Board,

As can be seen in Exhibit 1, the ratio of risk-weighted assets to total leverage exposure (RWA density) has declined by more than 17 percent, on average, across all eight U.S. GSIBs since the adoption of the eSLR in April 2014.<sup>5</sup> Further, the average density went from 51 percent in 1Q15 to 46 percent in 4Q19 and to 42 percent in 4Q20. Thus, the decline in average density registered during 2020 is nearly the same as the decrease that occurred between 2015 and 2019.



The decline in the RWA density before the Federal Reserve’s massive intervention to restore market liquidity was in large part driven by a reduction in risk-weighted assets because of adjustments to banks’ balance sheets following the adoption of Basel III. Indeed, between 1Q15 and 4Q19, RWA declined more than 5 percent while total leverage exposure rose nearly 4 percent.

The lower density of risk-weighted assets has contributed to an increased likelihood of a binding supplementary leverage ratio. We would observe similar trends in Tier 1 leverage ratios. The downward trend in RWA densities is expected to continue over the medium term as additional quantitative easing (QE) occurs and will result in more binding leverage ratios. For instance, during 2020 total leverage exposure would have risen more than 12 percent due to the increase in reserve balances, Treasury securities and agency MBS across the eight U.S. GSIBs.

In summary, a calibration that appeared reasonable back in 2014 when the eSLR was adopted is now considerably tighter. Namely, if 5 percent was the correct calibration for the eSLR back in 2014, it would be appropriate for such calibration to be adjusted an average 17 percent lower, or approximately to 4.2 percent, had the temporary

Vice Chair for Supervision, Randal K. Quarles, “A New Chapter in Stress Testing,” (Nov. 9, 2018), <https://www.federalreserve.gov/newsevents/speech/quarles20181109a.htm> (“As the Federal Reserve has long maintained, leverage requirements are intended to serve as a backstop to the risk-based capital requirements.”)

<sup>5</sup> For the fourth quarter of 2020, total leverage exposure in Exhibit 1 includes all temporary exclusions as well as central bank placements for custodian banks that are permanently excluded because of section 402 of the Economic Growth, Regulatory Relief, and Consumer Protection Act and implementing regulations.

exclusions not been in place.<sup>6,7</sup> Moreover, the adjustment would have to be larger (we project the eSLR buffer to be close to 4 percent) because reserve balances are expected to exceed \$5 trillion by the end of this year and the Federal Reserve's balance sheet will stay elevated for a long time. Without such an adjustment, leverage ratios are becoming relatively less of a backstop for risk-based capital requirements and more of the binding capital constraint. This increases the risk of a repeat of the recent repo market disruption and creates an incentive for banks to reduce low-risk, balance-sheet-intensive activities.

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<sup>6</sup> This adjustment is understated because it assumes the projected level of reserve balances would have been \$25 billion when in fact it was \$1.3 trillion by the time eSLR requirement was effective.

<sup>7</sup> The ratio of RWA to TLE can be expressed as the ratio of Tier 1 capital to TLE divided by Tier 1 capital to RWA. The ratio of those two requirements is  $5\% / (6\% + \text{buffers})$ . If the ratio of RWA to TLE falls 17%, then the ratio of the two requirements must also fall by the same percentage, or  $5\% * (1 - 0.17) = 4.2\%$