At Bloomberg, the Cure Is Worse than the (Misdiagnosed) Disease

Greg Baer | Apr. 30, 2025

An April 29 Bloomberg editorial claims that reform of the supplementary leverage ratio would be "irresponsible" and weaken banks by exposing them to greater Treasury risk. Leverage ratios ignore the risk of assets in assessing banks' capital adequacy and therefore strongly disincentivize the holding of relatively low-risk (and thus low-yielding) assets – a key need for banks that intermediate in capital markets, and the Treasury market in particular. Those low-risk assets include Treasury securities, and regulators and the Treasury Department are rightly concerned that market depth has not kept up with issuance and trading volume in that market. Reform to the leverage ratio would make it less likely to bind under stress conditions, and therefore make banks more willing to intermediate when markets are unstable and their services are most valuable.

First, Bloomberg's concern about the level of bank holdings of Treasuries ignores a crucial distinction. Most holdings of Treasury securities by large banks are *not* for purposes of intermediating in the Treasury market; rather, they are held to comply with stringent liquidity regulations that are currently under review by policymakers. Thus, we hope that Bloomberg will maintain consistency and support potential reform of liquidity requirements — that is, reform that emphasizes a bank's ability to access the discount window and other varied sources of funding rather than how much cash and Treasuries the bank holds on the asset side of its balance sheet. That reform would allow banks to make more loans and hold fewer Treasuries.

But even assuming it was focused on the right rule, Bloomberg's risk diagnosis is incorrect and its prescription dreadful. While Bloomberg argues that reform of the leverage ratio would weaken U.S. banks, it fails to note that the large U.S. dealers are part of global, diversified holding companies and are subject to a range of risk-based capital requirements as well as a stress test that yields a further capital charge. Even with a less stringent leverage ratio, those banks would still hold extraordinarily large levels of capital.

While the editorial opposes any relief for banks, it acknowledges a problem with intermediation in the Treasury market. So, what is the solution Bloomberg espouses? Per the editorial, "The Federal Reserve could provide more participants with access to its standing repo facility, which lends cash against the collateral of government bonds. In emergencies, it could even consider stepping in to prevent undue price distortions." Both involve a significant expansion of the role of the Federal Reserve in markets.

While Bloomberg does not identify which additional participants in the standing repo facility it has in mind, the answer is hedge funds. So, rather than allow banks to make markets in Treasuries in greater volume, the Federal Reserve would lend to hedge funds so that they can buy Treasuries. (That may at some point have to be part of the solution, but it is hardly the costless policy that Bloomberg suggests. And it is a far more drastic solution than leverage ratio relief.)

It is the second suggestion — the Fed "stepping in" — that is truly remarkable. Bloomberg's concern is that if banks add to their Treasury holdings, they are at risk of failure to the extent that Treasuries dramatically decline in value. Let's leave aside the unlikelihood of that scenario. It is more important to note that the concern here presumably is that if its Treasury holdings were to destabilize a major bank, government support for the bank would be necessary. *But **direct** government support — that is, the Federal Reserve becoming a market-maker of last resort, using taxpayer money — is exactly what Bloomberg proposes as the alternative.*

Furthermore, while many lament the highly leveraged basis trade that risks creating Treasury market instability, Bloomberg fails to note one major cause of the size of that trade: the Federal Reserve's *previous* intervention in support of the market, effectively establishing a Fed put. This moral hazard does not make its way into the Bloomberg calculus.

Worse yet, consider the optics of the Federal Reserve becoming a buyer of Treasuries at a time when there are questions about the credit quality of those securities. Earlier Fed interventions came when there were technical problems in the market, but imagine the impact of the Fed becoming the buyer of last resort. Remarkably, the Bloomberg editorial argues against allowing banks to increase Treasury holdings to avoid repeating the European "doom loop" of the 2010s, where banks were necessary to support the issuance of sovereign securities; one would think it far worse for the *central bank* to be the one supporting the issuance of sovereign securities.

The best, first answer is to allow banks to enhance their ability to intermediate in the Treasury market.

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