US Rates Watch

SLR & USTs: it won't matter much

SLR not a game-changer for Treasuries

Clients keep asking how supplementary leverage ratio (SLR) changes will impact UST demand. Our answer remains the same: it won't matter much. Clients tell us we are out of consensus. We were out of consensus in '21 when the initial SLR reserve & UST carve out expired; consensus believed it would have a meaningful negative impact on UST demand, we suspected it would not (see SLR.. unlikely to be extended). It did not matter.

We reiterate our long-held view that market participants may be disappointed by SLR reform impact on bank UST demand and dealer intermediation capacity. We continue to believe clients should be short 30Y spreads, mostly due to long end supply / demand imbalance and partially driven by de-reg disappointment. We acknowledge initial SLR headlines will see back-end spreads pop wider; clients should fade that move. We believe SLR is no "white knight" for UST demand; investors should not expect it will be.

History lesson: SLR didn't matter much in prior carve out

History offers one example of US SLR reserve & UST carve outs during COVID; it was initiated on April 1, '20 & expired on March 31, '21. Fed press release says the carve out was intended to "ease strains in the Treasury market" & increase "credit to households and businesses". Below we briefly review the history & conclude it did not matter much.

SLR reserve & UST exemption can impact 2 main market participants: banks and dealers. During the '20-'21 SLR adjustment bank UST holdings / assets grew relatively slowly vs subsequent years (Exhibit 1) & dealer UST holdings declined (Exhibit 2). If SLR mattered, bank & dealer UST holdings should have grown / grown more rapidly.

Some clients discount this history because (1) SLR temporary relief may have limited behavior shifts (2) Fed was engaged in very rapid UST purchases in '20-'21. We would argue that bank & dealer UST holdings didn't change much b/c SLR didn't matter. Other clients cite Fed research that proves more SLR constrained dealers were better able to expand their UST holdings vs non-SLR constrained dealers.[1] We would argue that aggregate dealer UST holdings did not grow. Our view: history lessons matter.

SLR today: banks & dealers suggest limited UST impact

We ask our bank & dealer clients: "how would your UST demand be impacted by SLR changes, including reserve & Treasury carve out?" Their answer: "not much".

…We elaborate in more detail on pages 2-4…

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[1] Boston Fed: "Evidence That Relaxing Dealers' Risk Constraints Can Make the Treasury Market More Liquid"

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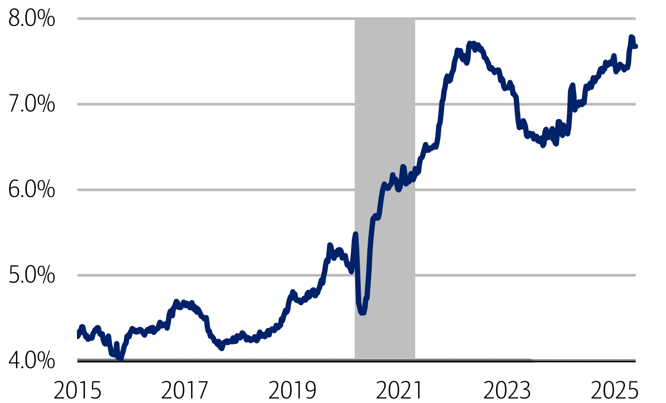
GSBI- Global Systemically Important Bank

Banks: commercial banks typically explain their answer to our SLR question in the following manner: banks typically only buy securities when their deposit growth (bank liability) exceeds their loan growth (ideal bank asset). When deposit growth > loan growth banks gain cash reserves on the asset side of their balance sheet that likely exceeds their need for intra-day liquidity and liquidity coverage ratio requirements. Banks can pick up yield by buying securities, and USTs have the same risk-weight and leverage capital consumption. If banks buy securities they will typically optimize: (1) returns (2) liquidity considerations. The SLR component of securities choices – including USTs – is zero since all have the same SLR need.

Exhibit 1: Bank UST to asset holding ratio
Bank UST holdings increased only modestly in prior SLR carve out period



Source: Bloomberg; note: shaded region = prior SLR UST & reserve carve out period
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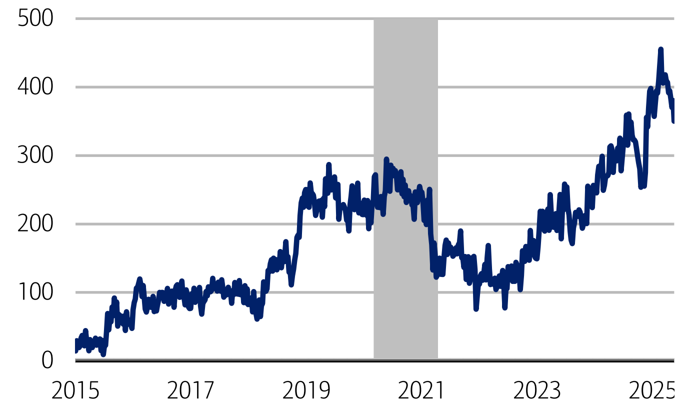
Exhibit 2: Dealer UST holdings ($bn)
Dealer UST holdings were stable or lower during prior SLR carve out period



Source: Bloomberg; note: shaded region = prior SLR UST & reserve carve out period
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Dealers: dealers typically suggest that SLR changes will only help if they are SLR constrained. Our understanding is that most bank-affiliated dealers are risk weighted asset (RWA) constrained; these dealers would likely welcome SLR changes that can give them more flexibility on their gross repo balances but suggest it is unlikely to materially increase their UST intermediation capacity (since they are RWA constrained). We understand that some traditional broker-dealers may be SLR constrained (or nearly) at times; theses dealers may be able to increase UST intermediation but are in the minority.

Overall, banks & dealers suggest SLR changes will not impact them much unless they are SLR constrained. Most are not. Therefore, SLR changes won't matter much.

Banks & SLR: UST tradeoff not attractive

When considering the SLR context for bank UST demand we think it is useful to consider the ways in which banks can theoretically grow their securities holdings. Banks can either swap existing assets into Treasuries – which is balance sheet neutral - or can add new Treasury holdings against new liabilities which is balance sheet additive.

Banks primarily have the funding options of repo, deposits and commercial paper. The typical bank activity is selling reserves to buy swapped USTs. This is the most natural switch because reserves and swapped USTs are both floating rate govt liabilities with similar liquidity value and capital consumption (reserves are slightly better on both). Reserves float at IOER flat while 2y UST swaps to SOFR+22bp, a substantial pickup, but at the cost of added spread PV01 risk.

This activity is seen as neutral for SLR capital because reserves and USTs are treated the same under leverage requirements (SLR). No matter how low SLR is, the trade out of reserves into USTs saves no capital. Reserves and USTs are also neutral on risk-weighted requirements (RW). Banks can also swap from GNMA to UST or Agency MBS to

UST, etc. But these asset re-allocations would incur loss of net interest margin and save nothing in the amount SLR capital consumed.

When banks add new balance sheet, any asset consumes the same amount of SLR. Asset yield vs funding cost is the carry to be judged against the risk. Using o/n repo or deposits at SOFR flat, swapped USTs below 10y maturity offer no more than 60bp of annual net interest margin vs typical bank NIM of overall 250bp-300bp. Unswapped USTs are lower in yield than repo funding and per duration provide less yield than GNMA, Agency MBS or whole loans per dollar of SLR capital.

Through conversations with banks we see price risk as their binding constraint for buying more USTs on spread. While a swapped UST generates a pick-up to reserves, this activity is exposed to mark-to-market which flows through to earnings unless accounted as held-to-maturity. Investors still monitor price risk of HTM portfolios. If the UST swap spread moves by X basis points, it creates X* UST_DV01 dollars of P&L. Lowering SLR does not ease this. Spread risk is now at a 10-year high.

Dealers: more RW vs SLR constrained

Dealers use repo funding for Treasuries and a Fed study showed that SLR-constrained dealers added more USTs in 2020 when SLR was reduced. Despite this, total dealer holdings fell in 2020. Today, dealers are risk weight (RW) constrained and so freeing up SLR capital we think will not free up any room for larger UST inventories within dealers. We recognize that some dealers are almost SLR constrained, and in those cases some dealers might have marginal scope for larger inventories. Dealers buy USTs when they are cheap enough vs futures or vs swaps or when end users need to sell. At the moment, with dealer inventories near all-time highs, it is not clear that appetite for SLR-constrained dealers is there to add if SLR is reduced.

New formula vs old: not a reduction forever

The SLR proposal currently supported by Powell and incoming Supervision Chair Bowman is the 2018 eSLR proposal which would reduce eSLR (enhanced supplementary leverage ratio, now 2% for GSIB dealers and 3% for GSIB depositories) to 0.5 times their GSIB surcharge score. A GSIB with GSIB score of 3.5% (top current size) would now have an eSLR of 0.5*3.5%=1.75% instead of the 3% (the higher of the bank and dealer). With today's 8 GSIB scores ranging between 1% and 3.5%, all 8 banks should experience a lower total SLR = LR + eSLR as the LR (leverage ratio) remains at 3% system-wide and the eSLR goes down.

But as GSIB balance sheets continue to grow over time, the 0.5*GSIB surcharge requirement could surpass today's 3%. In the long run, this proposal could therefore raise SLR requirements in the banking system and so arguably represents a long-run tightening of capital regs. In the short term, however, the proposal would reduce SLR for all 8 GSIBs. We are not aware of an capital proposal for other banks at this time.

GSIBs already hold large buffers

The 8 GSIB banks are not strictly capital constrained today. The combined GSIBs hold excess capital of around $70bn above and beyond all requirements (Exhibit 3). This implies that bank demand should not change if capital requirements are lowered, as capital buffers either remain stable or become larger. If banks were currently capital constrained, new asset creation or acquisition would be constrained and asset "mispricing" could exist without being seized upon by banks. Any attractive investment opportunity today, however, we think would be already seized upon in an environment where banks are over-capitalized.

Exhibit 3: GSIBs hold about $70bn of excess capital, ie demand should not be too constrained
Each capital metric is exceeded by a dollar amount (2nd rows) also expressed as a percentage (1st rows)

	JPM	C	WFC	GS	MS	BK	STT
CET1							
Excess CET1 (%)	3.1%	1.3%	1.3%	1.1%	1.8%	3.0%	3.0%
Excess CET1 ($bn)	56.6	15.2	15.8	7.6	9.0	5.1	3.9
SLR							
Excess T1C (%)	1.0%	0.8%	1.8%	0.5%	0.6%	1.9%	1.5%
Excess T1C ($bn)	51.5	24.0	40.6	10.8	9.3	6.8	4.0
T1 Leverage							
Excess T1L (%)	3.2%	3.1%	4.1%	2.8%	2.9%	2.2%	1.5%
Excess T1L ($bn)	133.8	77.5	79.3	48.4	36.5	9.3	4.9
Total Capital							
Excess RBC (%)	2.4%	1.4%	1.9%	1.8%	2.5%	3.7%	3.8%
Excess RBC ($bn)	43.7	18.4	23.0	12.5	12.6	6.3	5.0
Tier 1 capital							
Excess T1C (%)	2.7%	1.4%	1.3%	1.8%	2.2%	4.6%	4.3%
Excess T1C ($bn)	48.6	18.7	15.8	12.5	11.1	7.9	5.5
HoldCo Binding constraint	RBC	Stnd CET1	Stnd CET1	Stnd CET1	Stnd CET1	Stnd CET1	Stnd CET1
Excess Capital ($bn)	**43.7**	**15.2**	**15.8**	**7.6**	**9.0**	**5.1**	**3.9**
Bank SLR							
Excess T1C (%)	0.5%	1.3%	1.3%	2.0%	1.6%	2.1%	1.1%
Excess T1C ($bn)	21.5	27.3	25.5	16.4	4.9	5.8	3.1
Binding constraint	Bank SLR	Stnd CET1	Stnd CET1	Stnd CET1	Bank SLR	Stnd CET1	Bank SLR
Excess Capital ($bn)	**21.5**	**15.2**	**15.8**	**7.6**	**4.9**	**5.1**	**3.1**

Source: BofA Global Research

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SLR changes: why bother? How to help UST market?

After explaining our logic on why SLR changes are unlikely to matter for UST demand, clients frequently ask 2 questions: (1) why bother make any SLR changes? (2) what else can official sector do to improve the UST supply / demand imbalance. We address below.

Why bother to make any SLR changes? We believe SLR should be adjusted for 2 key reasons: (1) conceptually it makes no sense to require banks to capitalize their reserve or UST holdings; reserves have zero price or liquidity risk while USTs have zero credit risk (2) Some GSIB holdcos have SLR as a close 2nd in terms of binding constraints If risk-weighted capital requirements were lowered then SLR could become binding which is not the Fed's goal with SLR. We believe these are good reasons to lower SLR but are skeptical these changes will impact bank or dealer UST demand.

If SLR will not help UST market, what else can be done to support USTs? The UST market is suffering from an acute supply / demand imbalance, especially at the long end. The easiest way to support the UST market is to reduce supply (via lower fiscal deficits) but we know this is not politically attractive. Other options: (1) increase long-end UST buybacks (2) shorten UST issuance duration (weighted average maturity) (3) create greater incentives to own USTs (via other regulatory changes, i.e. exempt UST from all capital metrics). The market wants to believe SLR is a "white knight" for UST demand; we think other steps will be needed & lower fiscal deficits are the most optimal solution.

Bottom line: we believe SLR changes will not matter much for UST demand. In fact, we believe SLR changes & the associated impact will disappoint lofty market expectations. We recommend staying short 30Y UST asset swap spreads for this theme. If spreads pop wider on SLR headlines, we recommend fading the move. More durable support for the UST market can come through deficit reduction, UST buybacks, UST WAM shortening, or other regulatory changes like reducing risk-weighted capital consumption of the UST business for dealers.

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