GSE Activity Report

Friday, April 13, 2018

Making the eSLR Easier

Summary

On Wednesday, the FRB and OCC released proposed changes to the enhanced supplementary leverage ratio (eSLR) governing the largest U.S. banks. The day before, the Fed on its own proposed sweeping changes to how its CCAR stress test governs these same GSIBs. In this alert, we'll lay out the eSLR proposal and its housing-market impact. We'll turn next to CCAR and then to a wrap-up analysis putting the two complex rules together in a forward-looking assessment of how all of these changes fit in with pending legislation and the rest of the U.S. rulebook. The eSLR is a critical piece of this complex puzzle because it now stands as a costly barrier to private-sector mortgage origination, investment, and securitization for all of the big banks on which the business used to depend. As a result, regulated banks could play a considerably larger role in mortgage finance in concert with Treasury action ending the conservatorship.

Impact

As we noted when the eSLR was imposed and in subsequent analyses of various regulatory-capital changes, the eSLR has defined what big banks do ever since it was first proposed in 2013. It requires GSIBs to hold a 5% capital ratio regardless of asset risk at the BHC and a still tougher 6% leverage ratio at subsidiary insured depositories. As the new rule makes clear, the result is that the eSLR, not risk-based capital, is the binding constraint for all lead banks at each of the GSIBs. Because of this and the requirements in the liquidity rules that these same GSIBs hold large balances (now around 28% of total on-balance sheet assets) of government and agency securities, GSIBs have dumped any business that doesn't involve either a lot of fee-based revenue or high enough returns to make a reasonable return on capital after taking both the risk-based and leverage rules into account and then adding on specific provisions in CCAR (e.g., no credit for MI, added capital for put-back risk).

Rules as punitive as the eSLR have of course had significant impact beyond the residential-mortgage market. GSIBs were the backbone of the repo market, key to central clearing, and critical providers of custody-banking services before the eSLR. Now, they're either out of these businesses or far smaller players than they would have liked given all the infrastructure investment they had in these critical areas. The Fed honestly didn't think GSIBs would bow out when the eSLR was imposed – somehow, it missed the point that banks don't do businesses at which they can't make money. Now, it and the OCC have

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recanted, with the proposed rule expressly saying that its point is to make risk-based capital – not the leverage rule – each GSIB's binding constraint.

Although we doubt that big banks will quickly head back into repos and other core market infrastructure, the rules will make central clearing and custody banking less painful. Pending legislation to get one or both of these activities totally out of the eSLR would be the big bank's big win, but the proposed eSLR changes are nonetheless a considerable boost.

The NPR would replace the current eSLR with a requirement set at fifty percent of a GSIB's risk-based capital surcharge for parent companies and an LR for subsidiary banks of three percent (i.e., the SLR) plus fifty percent of the GSIB surcharge applicable to the holding company. This ratio would be necessary for the "well-capitalized" status but banks could hold somewhat less capital and largely avoid sanctions because they would still be "adequately capitalized" if leverage ratios do not fall significantly. Importantly, the NPR in general describes the eSLR now as a "buffer," not the "rule" it used to be. This implies that both BHCs and subsidiary banks could fall below the mandatory ratios – at least a bit – under stress. If this is continued in the final rule, large banks could shed more than the $121 billion in excess capital now calculated by the agencies because they could also drop the voluntary cushions they have kept to be above the minimums.

Where would excess capital go? Some would go to shareholders, of course, and some likely would be used for larger holdings of USG and agency paper to back any of the capital-markets activities which the GSIBs re-enter. However, all of this capital relief for the huge balances required by the liquidity rules also frees billions for new lending and related risk-taking positions. Lower-risk, lower-return obligations become very attractive again because the end of the high eSLR combined with reasonable risk-based weightings makes these assets winners assuming appropriate net interest margins, pricing, and similar considerations. More portfolio lending for lower-risk LMI and first-time homeowners? Likely, we think. New interest in lower-risk positions in credit enhancement and credit-risk transfer structures? Likely too. Ability to handle risk-retention pieces of otherwise-profitable PLS? Again, likely. Indeed, the GSIBs could be formidable competitors in mortgage securitization, credit enhancement, and other sectors in which their competition isn't the federal government.

Outlook

The comment deadline on the eSLR proposal is short – just thirty days from *Federal Register* publication. This is partly to deflect legislative action on the total eSLR carve-outs in the Senate bill, which the Fed opposes, and also to establish the eSLR regime ahead of acting on CCAR. That NPR has a sixty-day comment period and we expect it to be combined with the eSLR into a single package backed also by the FDIC once the agencies see where Congress lands, read all the comments, and write rules establishing the balance between risk-based and leverage capital in ways beyond those outlined above for just the eSLR.

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