GSE Activity Report

Monday, March 22, 2021

The Next SLR Skirmish and Why It Matters

Summary

As we predicted, federal banking agencies didn't back down: the SLR exemption for central-bank reserves and Treasuries is no more as of April 1. This is big, bad news to big banks flooded with deposits and eager to continue to distribute capital, but the longer-term, strategic question is what's next. The Fed – although not necessarily also the OCC and FDIC – also promised Friday to issue a proposal rewriting the SLR more substantively. How this happens is a major matter for mortgage finance.

Impact

As a short reminder, the supplementary leverage ratio (SLR) is 3% for banks and BHCs with assets over $250 billion unless they come under the enhanced SLR of 5% for BHCs and 6% for IDIs mandated for GSIBs and one custody bank. All of these banking companies are, though, also subject to a 3% overall leverage ratio under no-lower-than provisions in Dodd-Frank's Collins Amendment, although all custody banks are governed by a statutory exemption for their central-bank deposits.

Last May, the banking agencies decided to extend the exemption in the SLR denominator to all covered banks for central-bank deposits and Treasury obligations to give big banks more balance-sheet capacity to handle deposit inflows and various Fed emergency-liquidity facilities. As the fight over extending the exemption makes clear, this is a big deal – without the exemptions, the biggest banks lose about 10% of their balance-sheet capacity or, according to the banking agencies, over $1 trillion.

Still, the exemption is gone and not coming back unless a March/2020 crisis comes again upon us. Big banks will thus begin to recast their balance sheets to ensure capital-distribution capacity throughout the rest of the year and pour enormous energy into an SLR rewrite. First to what's in store without the exemption over the near term:

- still less big-bank interest in portfolio mortgage lending or appetite for credit enhancement;
- still higher barriers to deposit inflows that will move funding into prime MMFs and hike agency MBS demand; and
- heightened demand for fee income, including that related to mortgage securitization.

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As noted, the stakes in the final construct of the SLR are high:

- If the agencies decide to extend the exclusion for Treasuries, they might expand it to Ginnies and other full-faith-and-credit USG obligations. This will put still more pressure on GSE pricing.
- There could be an even more powerful push for an explicit GSE backstop to increase agency pricing and appeal to banks under the liquidity rules.
- There would be significantly more balance-sheet capacity with which to take advantage of forthcoming breaks in the risk-based capital applicable to low-risk mortgages.

Outlook

Friday, the Fed promised near-term action on the proposed SLR rewrite, but quick at the Fed is due, deliberate action everywhere else. Making substantive changes to the SLR denominator also will not be easy unless changes are limited due to ongoing Congressional controversy about "weaker" big-bank capital.

Whether the OCC and FDIC will follow the Fed's lead is also uncertain. The other agencies are very wary of leverage-ratio leeway, not joining the Fed's initial SLR exemption in a final inter-agency rule until the Fed conceded a key point that made SLR relief both voluntary and subject to prior notice that gave the other agencies a chance to ban an insured depository from upstreaming capital to the parent organization. At the least, this IDI-level restriction is for sure should other inter-agency disputes be reconciled.

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