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EUROPE: FISCAL POLICY IN ACTION

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US BANKS: LEVERAGE RATIOS UNDER PRESSURE

Céline Choulet

The exceptional measures taken by the US authorities to bolster the liquidity of companies and markets in response to the Covid-19 crisis have resulted in a significant expansion of bank balance sheets. Since the financial crisis of 2007-2008, regulators have tightened balance sheet constraints significantly. Fearing that leverage requirements could damage banks' ability to finance the economy and support the smooth functioning of financial markets, these have temporarily been relaxed. However, the Federal Reserve is unlikely to undergo a slimming regime that will scale back bank balance sheets for a number of years (and almost certainly not before the end of the period of relaxation of requirements). As a result, we cannot rule out the possibility that the leverage ratio constraint will return as quickly as it was removed.

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EUROPE: FISCAL POLICY IN ACTION

The Covid-19 shock has triggered a significant fiscal policy response by European Union member states. Even though it is likely to be short-lived, the 2020 recession will be historic. The fiscal response has therefore been essential in avoiding much more serious and longer-lasting economic consequences. Member states have not all been affected in the same way by the current crisis, and the scale of their fiscal responses varies. The European response has been one of the few positive aspects of the crisis. However, the challenges are not yet over. Levels of risk and uncertainty on both the public health and economic fronts will remain particularly high over the next few months. An agreement on a European recovery programme is therefore needed and there is little likelihood of any letting up in national efforts.

The Covid-19 crisis is an unprecedented shock for the global economy and the eurozone economy. The latter avoided recession in 2019 and there were some signs of a stabilisation of economic activity towards the end of the year. The Covid-19 pandemic has put an end to the expansionary phase in the eurozone, which is likely to suffer the deepest recession in its brief history during 2020.

Since mid-March 2020, the European Central Bank (ECB) has adopted a particularly proactive and flexible monetary policy in order to avoid a tightening of lending conditions and mitigate the risk of financial fragmentation within the eurozone. This very substantial monetary response has provided the breathing room needed for calm consideration of the fiscal stimulus package needed. After a bit of turbulence, sovereign spreads between member states (that is to say the interest rate differentials on the government debt issued by individual countries) seem to have come back under control despite the sharp expected rise in government debt this year.

The eurozone economies have made significant use of fiscal measures to support various economic agents (households, companies, the healthcare sector) during the crisis. A substantial (and long hoped for) response at the European level has backed up national fiscal measures. This range of support packages was necessary to protect production capacity and thus ensure the best possible conditions for an economic recovery from the crisis. What is the nature of the fiscal response in the different member states? Is the scale of national fiscal stimulus plans comparable and adequate in the light of the lessons of the past and the likely economic consequences of the pandemic? Is the coordinated European response, which seems to break established taboos, appropriate? This article will endeavour to go some way to answering these questions.

An unprecedented economic shock

The public health measures put in place to tackle the epidemic will have significant consequences for eurozone economies through both supply and demand channels and in increased uncertainty. According to certain estimates, lockdown measures will lead to an instantaneous contraction in economic activity of some 30% relative to a normal situation (i.e. without lockdown).

The most recent economic data give initial indications of the scale of the economic effects caused by the pandemic shock. The current crisis and public health measures have, however, made the production of statistics more problematic. One should therefore remain cautious in their interpretation. In the 1st quarter of 2020, eurozone GDP fell by 3.6% compared to the fourth quarter of 2019 (quarter-on-quarter, q/q). Although the comparison between the economic performances of eurozone member states remains difficult, Germany appears to be holding up better than its major European partners. German GDP fell by 2.2% in Q1 2020, compared to falls of 5.3%, for example, in both France and Italy. The economic situation in the eurozone is likely to worsen significantly further in the 2nd quarter, given the length of time spent in lockdown. Although some initial signs of recovery are emerging, leading economic indicators are still sending particularly negative messages. The shape of any eurozone recovery in the 2nd half remains highly uncertain. The degree to which lost economic activity will be restored could be lower than expected. The ECB recently stressed that in the worst case scenario, real GDP could fall by 12% in 2020 and remain below its pre-crisis level for several years.

The latest European Commission (EC) forecasts suggest that eurozone real GDP will contract by 7.5% in 2020, before recovering in 2021. This is greater than the eurozone's economic contraction during the economic and financial crisis of 2008-2009. The current recession could however prove to be shorter-lived, in the absence of any crisis in the banking and financial sectors or a collapse in international trade, two features of the 2009 crisis.

All eurozone member states will see a marked contraction in GDP in 2020 (Figure 1). The size of this will vary from one country to the next and will depend in particular on public health measures (length and severity of the lockdown) adopted to tackle the epidemic and the nature of fiscal support.

REAL GDP GROWTH FORECASTS FOR 2020

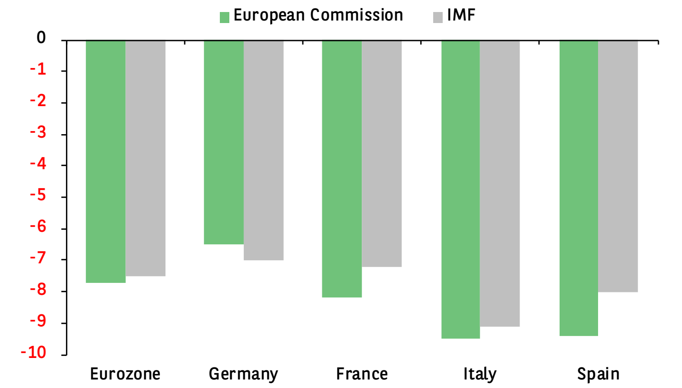

CHART 1

SOURCE: WEO IMF, EUROPEAN COMMISSION, BNP PARIBAS

Significant support at a national level

Swift fiscal response from member states

Faced with the shocks caused by the pandemic, eurozone member states reacted fairly quickly, and at a substantial scale, using fiscal measures. By acting as a macroeconomic stabiliser, the fiscal response of member states aims to maintain production capacity (reducing the risk of business failures and layoffs) in order to ensure a vigorous recovery from the crisis.

Governments have used three main fiscal instruments. First an immediate fiscal stimulus, which has taken the form of widespread use of short-time working schemes[1], payments of subsidies or the cancellation of tax or social security payments. Then, cash flow support for companies and households through deferrals of tax or social security payments. Lastly, provision of liquidity support, most notably in guarantees for loans to companies.

All of these measures, of whatever type, provide support to economic activity in the eurozone. That said, not all measures have the same effect on the public finances.

In this article, we will draw the distinction between 'direct' measures, that have an immediate fiscal impact, and 'indirect' measures, such as those used to underpin liquidity. This distinction has been used by most international organisations in their recent work on the effects of the crisis on GDP and public finances in the eurozone. Financing of short-time working measures represents an immediate government outlay. Meanwhile, in the case of a government guaranteed loan, for example, government debt will only be affected if the guarantee is triggered, that is to say if the borrowing company cannot meet its obligations.

Of the direct measures, one of the flagship policies adopted by nearly all member states, has been the use of short-time working ('chômage partiel' in France or 'Kurzarbeit' in Germany). These programmes are relevant in the current context[2] and their introduction draws on recent historical precedent. In the major recession of 2008-2009, Germany, in particular, made substantial use of this job protection approach. Although German GDP fell by 5.6% in 2009, employment proved resilient, and the German unemployment rate remained under control. France, which made less use of short-time working schemes, suffered a lasting increase in unemployment, despite a shallower recession. It should be noted that although a number of eurozone countries – including Germany, France, Italy, Spain and Belgium – have introduced short-time working measures, the details of the scheme vary from one to the next.

The use of fiscal tools varies in scale between eurozone members, and the types of tools used also vary (direct and indirect measures)[3].

Overall, direct measures have made up the smaller part of the fiscal support provided by the major member states to their economies (Figure 2). Over and above short-time working, eurozone economies have most notably provided support to small and mid-sized companies, through direct transfers, and to the self-employed. There have also been increases in public healthcare spending, including the purchase of medical equipment. In contrast, the US and Japan appear to have focused more on direct measures. In Japan, the steps taken included most notably the direct distribution of cash to the households hit hardest by the health crisis. Germany and Italy, meanwhile,

FISCAL RESPONSES (% OF NATIONAL GDP)

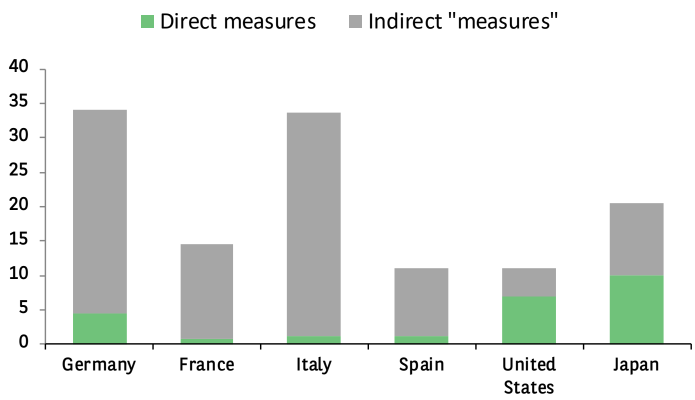

CHART 2

SOURCE: IMF FISCAL MONITOR APRIL 2020

Note: The measures identified here were taken from the latest edition of the IMF Fiscal Monitor. Only measures introduced prior to 6 April are included.

FISCAL RESPONSE AND 2020 GROWTH

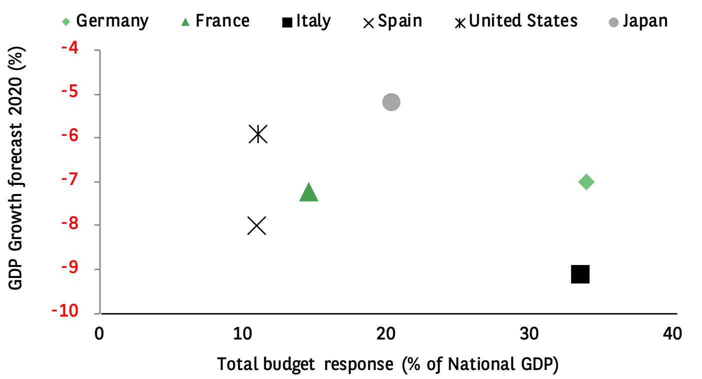

CHART 3

SOURCE: IMF, WEO AND FISCAL MONITOR

have introduced massive government guarantees to limit the risk to refinancing of private non-financial companies.

In order to offset the loss of activity resulting from public health measures (it is worth remembering that this loss is estimated at around 30% relative to normal circumstances), fiscal support should in theory be proportional to the loss. This might lead one to the conclusion that the countries hit hardest economically would see a higher level of government support than those less affected. However, when looking at all the fiscal measures brought forward (both direct and indirect), this is not necessarily what we find. Both Germany and Japan, for example, have adopted more substantial fiscal measures than Spain, even though the latter will suffer a greater economic shock.

1 Short-time working schemes enable companies facing economic difficulties to reduce the number of hours worked by their employees. Employees receive payments that may be fully funded by the government.
2 C. Berson et al., L'activité partielle, un outil précieux en temps de crise, (Short-time working, a valuable tool in a crisis) Bloc-notes Eco, Banque de France, April 2020
3 The classification of a measure by type depends on methodological choices and can therefore vary between analyses. For example, some analyses might treat a proportion of deferred tax payments as a cancellation, and therefore a direct expense, whilst others may treat it as a deferral. Moreover, since this article was written additional fiscal measures have been announced by euro zone governments.

Rapid fiscal expansion in 2020

According to the latest forecasts from the European Commission[4], the aggregate government deficit in the eurozone is likely to increase significantly, from 0.6% of GDP in 2019 to 8.5% of GDP in 2020. The budget balance in the eurozone has been improving steadily since the sovereign debt crisis of 2010-2011; indeed the primary budget balance (that is to say before interest payments) has been in surplus since 2014.

The trend in government deficits in the eurozone in 2020 reflects the interplay of the automatic stabilisers and the direct fiscal measures taken by governments, as discussed in the preceding section. The deficit is essentially affected by changes in public spending. The ratio of public spending to GDP will go up significantly, rising by 8 points of GDP (to 55.2% of GDP) under the effect of the discretionary measures introduced and the contraction of nominal GDP. Social security benefits (in cash) will rise sharply (particularly as a result of short-time working schemes), as will public sector consumption and subsidies. Public sector investment will increase only slightly. The revenue ratio (taxes and social contributions over GDP) will be more or less stable.

Given the steeper decline in economic activity than during the 2008-2009 crisis, the increase in the ratio of public spending to GDP is likely to be greater. This observation holds true in the eurozone (8.1pp increase in the ratio in 2020, compared to 4.1pp in 2009), but also in individual member states including Italy (10.4pp compared to 3.3pp), Germany (8.8pp compared to 4.0pp) and to a lesser extent France (7.2pp compared to 3.9pp).

The eurozone's fiscal policy will be highly expansionary in 2020. Changes in the structural primary balance (corrected for interest payments), or primary structural adjustment (see box), is a measure that is often used to determine the direction of fiscal policy. The primary structural adjustment in the eurozone in 2020 will be -3.25 percentage points of potential GDP according to the European Commission.

This fiscal expansion is very noticeable in comparison to past patterns, and is shared across most eurozone member states. The easing of fiscal policy in Germany and Italy will be particularly sizeable in 2020. These two countries generally run a structural primary surplus, which is therefore likely to narrow significantly, at least temporarily.

Budget balance, structural balance and structural adjustment

The budget balance of governments corresponds to the difference between government revenues and spending. The budget balance consists of a cyclical element (cyclical balance) and an underlying or structural element (structural balance).

Changes in the cyclical balance are affected by cyclical factors, and are generally calculated with reference to the economy's position in the economic cycle (output gap). The structural balance can thus be obtained by removing the cyclical balance from the total balance.

In the context of this article, it is the structural component of the government budget balance that interests us the most. More precisely, the issue is the change in the structural balance, or structural adjustment, which is crucial as it defines the direction of fiscal policy (expansionary or not).

The change in the structural balance consists of a discretionary component (structural effort) and a non-discretionary component:

1. The structural effort (or discretionary component) in turn consists of a revenue effort and a spending effort. The revenue effort is estimated on the basis of new revenue-raising measures (taxes and social security contributions) introduced by governments. The spending effort compares the effective change in public spending relative to a 'counterfactual' baseline. Frequently, the potential growth line is used to provide the baseline. The spending effort thus depends on the growth differential between government spending and potential growth. If government spending grows faster than potential GDP, the public finances will deteriorate.

2. The non-discretionary component includes other government, i.e. excluding taxes and social contributions (dividends for example), together with the effects of the elasticity of the tax take to GDP.

EUROZONE: BUDGET BALANCE AND PRIMARY BUDGET BALANCE (% OF GDP)

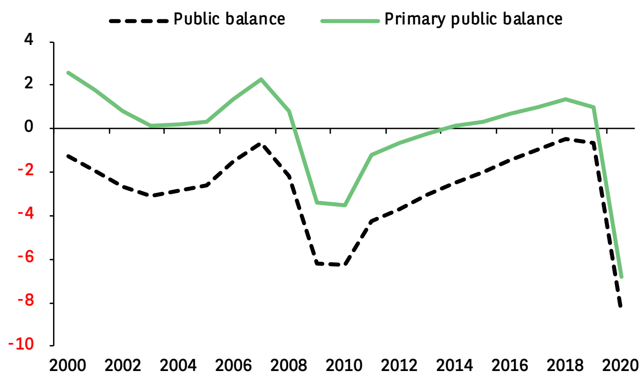

CHART 4 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

EUROZONE: PUBLIC SPENDING TO GDP RATIO AND CONTRIBUTIONS

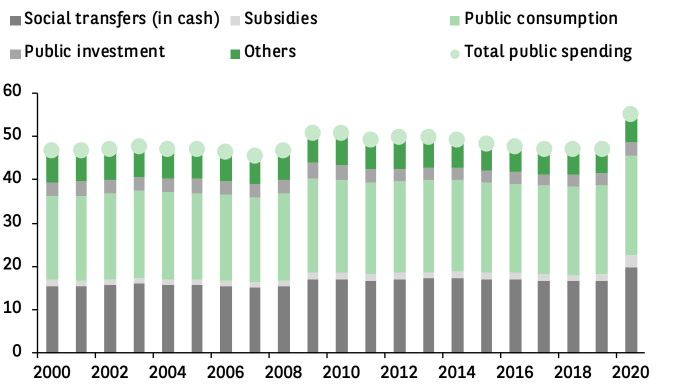

CHART 5 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

4 European Economic Forecast, Spring 2020, European Commission, May 2020

CHANGE IN STRUCTURAL PRIMARY BALANCE
(IN POINTS OF POTENTIAL GDP)

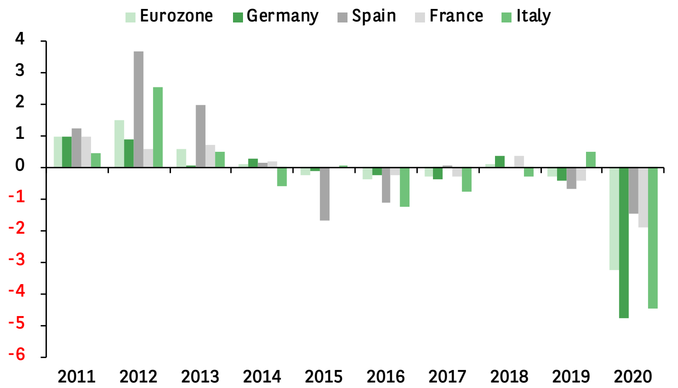

CHART 6

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

Government measures backed by a long-awaited European response

An encouraging initial response

Europe seems to have taken a more proactive and countercyclical stance than it has in the past. Constrained too tightly by European fiscal rules during previous crises, member states' public finances were not able to play their full role in macroeconomic stabilisation. Following the sovereign debt crisis, for example, the fiscal policies of several countries, in particular those limited by the Stability and Growth Pact (SGP), were restrictive with regard to their still negative economic positions[5]. Excessively swift fiscal tightening had a lasting negative effect on growth trends and limited the regaining of lost ground. This situation is likely to be avoided following the Covid-19 crisis.

The European response to the current crisis thus marks a degree of progress. First, fiscal rules have been relaxed. Finance Ministers and the European Commission (EC) have agreed that the conditions of the General Escape Clause have been met. This clause allows the waiver of certain limits set by the preventative and corrective arms[6] of the SGP in the event, most notably, of a severe economic downturn in the EU or the eurozone. This more flexible approach to European fiscal rules was a necessity given the economic shock caused by the pandemic. Public debt is expected to increase significantly (it is likely to hit 102.7% of GDP in the eurozone in 2020, from 86% in 2019), but the short-term risks of an increase in long-term yields and a widening of spreads against the German Bund have been mitigated by the massive response provided by the European Central Bank (ECB). Following hard on the heels of the triggering of the General Escape Clause, a proposal for EUR32 billion in investment (under the EU budget) to help tackle the economic consequences of the pandemic was approved by the European Parliament and introduced at the very beginning of April. This relatively small amount (0.2% of EU GDP in 2019) made the initial European response look somewhat timid. The Eurogroup meeting of eurozone finance ministers on 9 April provided some additional encouragement, suggesting several measures in response to the crisis.

Additional measures proposed by the Eurogroup[7] to tackle the crisis amount to a package worth EUR540 billion (or around 4.5% of eurozone GDP). They include a range of approaches, but overall seek to focus on the consequences of the current crisis, in such a way as to avoid issues of moral hazard and thus the risk of a veto by certain member states. First, a budget line (Pandemic Crisis Support) has been activated under the European Stability Mechanism (ESM) framework, specifically allocated to the management of the Covid-19 crisis. This line, without strict conditionality – this is a key point – will total EUR240 billion (which for each country corresponds to 2% of GDP).

The effectiveness of this measure remains unclear and will depend on the take-up rates by member states for this credit line. Take-up will presumably increase as the interest rate differential between the market rate and the MES rate increases[8]. Using the MES facility becomes attractive for a government if this differential is positive. Loans made under this facility will have a maximum average maturity of 10 years, which might be explained by the fact that this credit line is explicitly linked to Covid-19.

Other noticeable proposals from the Eurogroup included the temporary introduction of the Support to mitigate Unemployment Risks in an Emergency (SURE) programme. This consists of financial support for the length of the crisis in the form of loans from the European Union to member states on favourable terms. These loans are intended to respond to the increase in unemployment and the use of short-time working measures and the related social transfers. The maximum total amount is around EUR100 billion, drawn from the EU budget. As indicated by the European Commission, this temporary measure can be considered as an emergency unemployment insurance mechanism in response to the current crisis[9]. It therefore represents an interesting move towards greater European solidarity. However, such progress does not excuse European leaders from considering a true supranational mechanism for automatic stabilisation[10]. The total of EUR100 billion allocated to the SURE programme is crucial. Although such a sum might appear sufficient to address the massive and brutal collapse of the labour market during the lockdown period, it might need to be increased once lockdown is over to ensure a strong recovery. An increase in unemployment over the coming months is inevitable.

Lastly, April's meeting of the Eurogroup strengthened the role of the European Investment Bank (EIB), through the creation of a pan-European facility to guarantee EUR200 billion of loans, particularly targeting SMEs. The collapse in demand addressed to certain companies, without necessarily creating solvency risks, has resulted in increased demand for liquidity, which cannot be met by banks, which are themselves under pressure. Supporting these businesses, and thus productive capacity, is essential for the economic recovery and potential output over the medium term.

5 A. Bénassy-Quéré et al, Which fiscal union for the euro areas?, Conseil d'Analyse Economique, February 2016
6 The preventative section of the SGP relates to the path of the structural budget deficit (Medium-Term Objective or MTO), whilst the corrective arm provides for the measures to be taken if target levels for government debt and deficit are exceeded (60% of GDP and 3% of GDP respectively).
7 These measures have since been approved by the European Council.
8 J. Creel et al, It seems like it's raining billions, OFCE Le Blog, April 2020
9 Council Regulaton on the establishment of a European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) following the COVID-19 outbreak, European Commission, April 2020
10 F. Vandenbroucke et al., The European Commission's SURE initiative and euro area unemployment reinsurance, April 2020

European debt issuance: a remarkable step forward

After the agreement in principle reached by heads of state at the European Council meeting on 23 April 2020, the European Commission brought forward proposals concerning the Recovery Fund. This fund will receive EUR750 billion, a figure higher than that proposed by German Chancellor Angela Merkel and French President Emmanuel Macron. This represents a remarkable shift, going beyond the European budget, which does not take account of the economic situation. The launch of the fund is based on the issue of debt on the financial markets in the name of the European Union rather than any additional contribution from member states. This collective debt will have long maturities. The overall plan includes a substantial element of direct grants (EUR500 billion), equivalent to 3.5% of GDP in the EU27. These grants will be paid during the early years of the next EU budget cycle, from 2021 to 2024, and will not be repaid individually. The remaining EUR250 billion will be distributed in the form of loans to member states. The money will be invested across three pillars: 1/ support to Member States with investments and reforms 2/ providing solvency support to companies and incentivising private investments to kickstart the economy 3/ health-related initiatives. The proposal is ambitious because of its focus on preparing for the future, i.e. the move towards climate neutrality and the digital transition: the right investments today not only support growth in the short run but also make the EU better equipped to cope with future challenges. The access to financing is taking place on the initiative of the member states, i.e. on a voluntary basis. Member States will have to submit national 'Recovery and Resilience plans' which are coherent with the long-term strategies of the EU and set milestones. They will be discussed with the Commission in the context of the annual cycle of policy coordination, the so-called European Semester, following which access to financing will be made available.

This proposed Recovery Fund, if it is passed by all member states, will not turn Europe into a fiscal union. However, it does send a positive signal to investors: Europe is capable of providing a joint response to a severe economic crisis[11]. The negotiations are likely to be difficult, as some countries have already expressed reservations about this instrument. Austria, Denmark, the Netherlands and Sweden have indicated that they will not accept measures that imply a mutualisation of debt and a substantial increase in the European budget. It is hard to envisage failure, but as unanimous agreement is required, the negotiations threaten to be lengthy and it is to be hoped that they do not result in a significant watering down of the economic impact of the plan.

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The epidemic seems to have been brought under better control in many European countries. Its economic consequences remain uncertain, and most analysts are now predicting a more timid recovery than initially thought. So far, the response of the EU and national governments has matched the scale of the crisis. But the story is far from over. There is a considerable risk that there will be a sharp rise in unemployment and business failures; ambitious national recovery plans are thus expected soon. At the European level, the proposed Recovery Fund also needs to be approved and implemented without delay.

Completed on 15 June 2020

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11 C. Odendahl et al., The recovery fund faces a tricky passage, Centre for European Reform, June 2020

US BANKS: LEVERAGE RATIOS UNDER PRESSURE

The exceptional measures taken by the US authorities to bolster the liquidity of companies and markets in response to the Covid-19 crisis have resulted in a significant expansion of bank balance sheets. Since the financial crisis of 2007-2008, regulators have tightened balance sheet constraints significantly. Fearing that leverage requirements could damage banks' ability to finance the economy and support the smooth functioning of financial markets, these have temporarily been relaxed. However, the Federal Reserve is unlikely to undergo a slimming regime that will scale back bank balance sheets for a number of years (and almost certainly not before the end of the period of relaxation of requirements). As a result, we cannot rule out the possibility that the leverage ratio constraint will return as quickly as it was removed.

The US economy is facing its most serious crisis for 70 years. Initial estimates suggest that GDP could have contracted by 15% (quarter-on-quarter) in the second quarter of 2020, following a 1.3% contraction in the first quarter. In order to mitigate the economic consequences of the Covid-19 pandemic, the Treasury and the Federal Reserve (Fed) have made some major fiscal, monetary and regulatory decisions since mid-March. These have included exceptional measures to bolster the liquidity of companies and markets. These measures have led to a sharp worsening of bank debt leverages[1].

RAPID GROWTH IN BANK BALANCE SHEETS

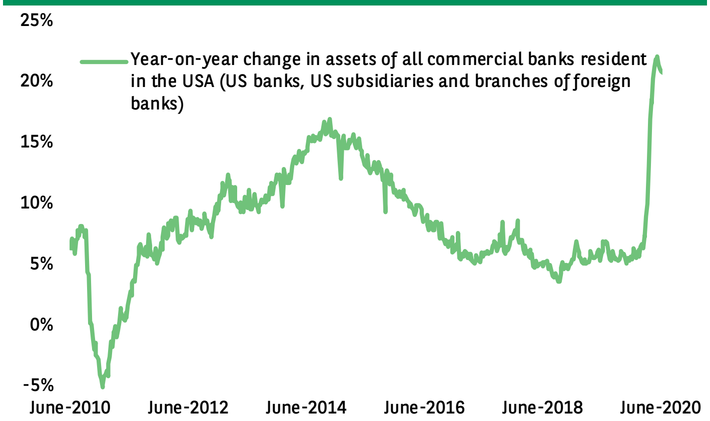


CHART 1 SOURCE: FEDERAL RESERVE (H.8)

Indeed, bank balance sheets have expanded considerably since mid-March (Chart 1). Drawing against confirmed credit lines (recorded as off-balance sheet items before they are paid out) and issuance of guaranteed loans under the Paycheck Protection Program (PPP)[2] have both increased balance sheet assets. Whether they have acted as intermediaries, direct counterparties or correspondent banks, US banks have also seen their central bank reserves increase substantially following the monetary policy measures taken by the Fed (securities purchasing, emergency loans, specific refinancing schemes, liquidity swaps with foreign central banks). Lastly, the fresh expansion in inventories of Treasuries by specialised primary dealer subsidiaries has also resulted in the expansion of consolidated balance sheets. Although loans guaranteed by the federal government (PPP loans), like reserves at the Fed and US Treasuries, have a zero risk weighting (for the risk-weighted capital ratios), they are included in the calculation of leverage exposure (as the denominator of the leverage ratio[3]).

Concerned that leverage requirements would hamper banks' capacity for credit intermediation and their activity in the Treasuries market, regulators have temporarily relaxed the rules. For one year, banks' reserves at the Federal Reserve and Treasury securities, whether used as collateral or not, may be deducted from the leverage ratios of large holding companies and depository institutions. With little prospect of the Fed reducing markedly its balance sheet (and therefore automatically central bank reserves) in the short term, regulators could be forced to extend the exclusion of reserves from leverage exposure for a lengthy period.

Relaxation of balance sheet constraints

Leverage constraints in the USA

In the USA, several leverage ratios exist side by side.

All banking organisations are subject to a simple leverage ratio which compares Tier 1 capital to average balance sheet assets. The minimum level is set at 4%.

Smaller depository institutions (those with consolidated assets of less than USD10 billion, community banks), that seek exemption from any capital adequacy measure based on risk-weighted assets, have a tougher minimum level[4] of 9% (Community Bank Leverage Ratio or CBLR)[5].

Only the biggest banks (those with total assets of more than USD250 billion or at least USD75 billion in non-bank assets, weighted short-term wholesale funding or off-balance sheet exposure)[6] are subject to the Basel supplementary leverage ratio (SLR) requirement. This compares Tier 1 capital to total exposure, which includes all assets recognised on the balance sheet[7] in accordance with applicable

1 For a banking organisation, debt leverage corresponds to the ratio of the book value of assets and the book value of shareholders' equity.
2 A programme of loans to small businesses guaranteed by the federal government via the Small Business Administration. Only the share of PPP loans used as collateral under the Fed's Paycheck Protection Program Lending Facility (PPPLF) is excluded from leverage calculations.
3 Such rules seek to guarantee that the total exposures and commitments of a bank, irrespective of the associated level of risk, do not exceed a certain multiple of its capital. The leverage ratio is defined as the inverse of debt leverage, that is to say as the ratio of equity to total exposure.
4 In accordance with the recommendations of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), passed into law by President Trump in May 2018 (section 201 of EGRRCPA).
5 Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Capital simplification for Qualifying Community Banking Organizations, September 2019.
6 The final rules, Changes to applicability thresholds for regulatory capital and liquidity requirements and Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations of 10 October 2019, modified the application thresholds for enhanced capital and liquidity requirements.
7 Items excluded from Tier 1 capital in the numerator of the ratio (e.g. holdings in entities excluded from the calculation of regulatory capital) must also be deducted from the balance sheet exposures in the denominator.

accounting rules (excluding derivative exposures and securities financing transaction exposures which are treated separately), and a reduced measure of off-balance sheet commitments[8]. Derivative exposures and securities financing transaction (SFT) exposures are measured on the basis of gross values; netting of certain lines is allowed only under restricted conditions (see Box). The minimum level for the SLR is set at 3%.

The SLR requirement for banks predominantly engaged in custody, safekeeping and asset servicing activities (such as Bank of New York Mellon, State Street and Northern Trust) was relaxed in November 2019[9]. The new rule[10], in force since 1 April 2020, excludes from the definition of their leverage exposure (the denominator of the Basel leverage ratio) a proportion of excess reserves held with the central bank[11] (equivalent to the amount of deposit liabilities that are linked to fiduciary or custody and safekeeping accounts). This exclusion covers not only deposits at the Fed, but also those with central banks in other OECD countries.

The eight global systemically important banks (G-SIBs) are subject to an enhanced requirement on consolidated figures (enhanced Supplementary Leverage Ratio, or eSLR, set at 5%) and for their depository institution subsidiaries (eSLR of 6%)[12].

The relaxations introduced since March

Regulators have not relaxed the basic leverage ratio. The Dodd Frank Act (Collins amendment, section 171) limited their scope to do so by requiring that any minimum weighted capital or leverage requirement is no lower than "generally applicable requirements" in force at the time the law was passed. In summary, the July 2010 act created a permanent floor for any new capital adequacy rule. In the absence of a vote in Congress, the leverage ratio cannot be reduced below that in force in 2010 (set at 4% for the ratio of Tier One capital to average balance sheet assets).

The three banking regulators (Fed, FDIC and OCC) have, however, been able to neutralise the impact of participation on two specific schemes introduced in response to the pandemic: the Money Market Mutual Fund Liquidity Facility (MMLF)[13] and the Paycheck Protection Program Lending Facility (PPPLF)[14]. Under interim rules, published on 19 March[15] and 9 April[16] respectively, assets used as collateral for the MMLF and the PPP loans used as collateral for the PPPLF can be excluded from the calculation of all leverage ratios applied in the USA, namely average consolidated assets for the calculation of the basic leverage ratio and the CBLR and the total leverage exposure used in the calculation of the SLR figure[17].

On 6 April, the three banking regulators (Fed, FDIC, OCC) relaxed the specific leverage constraint for community banks, in accordance with section 4012 of the Cares Act, introduced on 27 March[18]. The minimum level for CBLR was reduced to 8% from the second quarter of 2020.

A grace period of two quarters was accorded to community banks whose leverage ratio falls below 8% but remains at 7% or above. This relaxation will remain in force until 31 December 2020, or the end of the state of emergency if this comes sooner. The minimum will be

Treatment of securities financing transactions in the leverage exposure

The Basel Committee has defined the leverage exposure, the denominator of the Basel leverage ratio (SLR in the USA) in such a way as to correct for differences in accounting treatments between IFRS and US GAAP. The divergence between accounting standards with regard to the netting of financial assets and liabilities results in notable differences in the reported size of bank balance sheets (for identical transactions) on either side of the Atlantic. Under US GAAP, netting of derivative exposures and securities financing transaction exposures (securities borrowing or lending transactions, repurchase or reverse repurchase agreements), and thus the recognition of a net balance on the balance sheet, is more commonly used than under IFRS.

Under the Basel rule (and its implementation in US law) the leverage exposure measure includes a specific treatment of securities financing transactions (SFTs): 1/ It includes the gross value of SFT assets recognised for accounting purposes but with no recognition of accounting netting of cash payables against cash receivables; 2/ Under US GAAP, in a security-for-security repo-style transaction, the securities pledged as collateral by the borrowing bank are recognised on the balance sheet of the lending bank where the bank has received the right to sell the securities or re-use them as collateral (but continue to be included on the balance sheet of the borrowing bank). The Basel regulations allow for the exclusion of the "received" securities from the leverage exposure of the lending bank, provided that they have not been re-pledged as collateral; 3/ Cash payables and cash receivables in SFTs with the same counterparty may be measured net under certain conditions (the transactions have the same explicit date of final settlement; the right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable, even in the event of default, insolvency or bankruptcy; the counterparties intend to make a net or simultaneous settlement); 4/ The measure of leverage also includes a measure of counterparty risk relating to the SFT and a measure of exposure where the bank is acting as an agent.

Under US GAAP, securities financing transactions are, in general, recognised as secured borrowings coupled with an undertaking to repurchase the security on maturity. In other words, the securities used as collateral under a repo agreement or a security borrowing transaction are not derecognised on the borrower's balance sheet. The transaction gives rise to a transfer of the legal ownership of the securities used, but not their economic ownership. A derecognition of the securities can only take place where there is a transfer of the effective control of the securities (the right to receive any associated income stream); in this case the transaction is treated as a sale.

In practice, for major banks, measurement of exposure to SFTs is limited to the net value recognised on the balance sheet under US GAAP increased by a measure of associated counterparty risk, which reflects the fact that SFTs recognised as sales are probably marginal and that the conditions for netting cash payables and cash receivables are met in the majority of cases.

8 The measurement of off-balance sheet exposures using the credit exposure equivalent conversion factors of the standardised Basel approach, adding a floor of 10%. A uniform 10% conversion factor is used for exposures that are unconditionally cancellable.
9 In accordance with Section 402 of the EGRRCPA.
10 Department of Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation (2019), Regulatory Capital Rule: Revisions to the Supplementary Leverage Ratio to exclude certain central bank deposits of banking organizations predominantly engaged in custody, safekeeping, and asset servicing activities, Final rule, November 2019.
11 Figures for reserves held in excess of required reserves no longer have meaning as the Fed removed its minimum reserve requirement as part of its updated monetary policy of 15 March (reduction in required reserve coefficient effective from 26 March).
12 Department of Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation (2014), Regulatory Capital, Revisions to the Supplementary Leverage Ratio, Final rule, September 2014
13 Under this scheme, the Federal Reserve of Boston makes secured loans to banks. The eligible collateral consists of assets purchased from money market funds (US Treasuries, MBS and debt securities issued by the Agencies, ABCP and unsecured commercial papers issued by investment-grade US counterparties, and US municipal short-term debt). The scheme is due to last until 30 September 2020.
14 The PPPLF programme allows banks to obtain liquidity against loans made to small businesses under the Paycheck Protection Program introduced by the Cares Act. The principal amount and maturity of the secured loans made by the Fed to eligible borrowers match those of the PPP loans pledged as collateral (whether these were originated by the borrower itself or purchased from other institutions). The scheme has no upper limit and is due to last until 30 September 2020.
15 Department of Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation (2020), Regulatory Capital Rule: Money Market Mutual Fund Liquidity Facility, Interim final rule, March 2020.
16 Department of Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation (2020), Regulatory Capital Rule: Paycheck Protection Program Lending Facility and Paycheck Protection Program Loans, Interim final rule, April 2020.
17 Assets pledged as collateral to the MMLF and the PPPLF can also be excluded from the risk-weighted assets calculated under advanced approaches and standardised approach.
18 Department of Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation (2020), Regulatory Capital Rule: Temporary Changes to the Community Bank Leverage Ratio Framework, Interim final rule, April 2020.

increased to 8.5% on 1 January 2021 and then 9% in 2022, taking it back to its level at 1 January 2020.

The Basel SLR requirement has been relaxed under two interim rules. First, in April, the Fed announced a provisional modification for the calculation method for the SLR for bank holding companies, saving and loan holding companies and US intermediate holding companies of foreign banking organisations[19]. The new calculation method will apply from 1 April 2020 to 31 March 2021, and excludes Treasuries and reserves at the Fed from the denominator of the ratio[20]. Then in May, the FDIC and OCC joined forces with the Fed to extend the new SLR calculation method to all depository institutions with balance sheets of more than USD250 billion (subject to Category II and III capital standards) or subsidiaries of US G-SIBs[21].

Little room for manoeuvre

A deterioration of leverage ratios

The SLRs of certain large banking groups dropped in the first quarter of 2020 on a consolidated basis and/or at some of their main depository institution subsidiaries (Charts 2 and 3).

However, the reported fall understates the deterioration of debt leverages. This is because the denominator of the SLR is calculated as the average of positions booked during the quarter: total exposure is the sum of the daily average of balance sheet exposure and the average of the three month-end amounts of off-balance sheet exposure. As the Covid-19 crisis only began to have significant effects on bank balance sheets from March, the increase in leverage ratios is not fully reflected in the first quarter figures.

The new definition of total exposure has given SLRs a significant boost

There is no doubt that the exclusion of reserves at the Fed and Treasuries from the definition of total exposure frees up a not insignificant quantity of capital[22] (Tables 1 and 2).

The aggregate amount of deposits at the Fed for all depository institutions has already exceeded its previous record, set following QE3 in October 2014 (USD2,820 billion). From USD1,550 billion at the beginning of the year, reserves at the Fed had risen to USD2,350 billion by the end of the first quarter before surging to USD3,260 billion on 3 june (Chart 4). Nor has the upward trend in reserves yet run its course. All things being equal, continued expansion of the Fed's balance sheet through asset purchases (QE) and the Treasury's plan to reduce its holdings at the Fed (to USD800 billion, from USD1,430 billion at 3 June) will increase the bank reserves held with the Fed by at least USD1,000 billion by the end of September[23]. Granted, the maturing of the Fed's liquidity swaps will automatically destroy some of the reserves created[24], but the possible increase in the scale of measures to support lending to small and medium-sized businesses could support their expansion.

In general terms, the exclusion of Treasuries has improved SLRs for depository institutions whose portfolios of Treasuries have expanded in recent years, and for holding companies whose subsidiaries include the main US primary dealers (Chart 5). The relaxation of the constraint will also allow primary dealers to 'absorb' the massive issuance of Treasuries planned for the second and third quarters of 2020 to help finance the economic support package (nearly USD3,700 billion in net issuance).

SLRS AT THE 4 BIGGEST BANKS

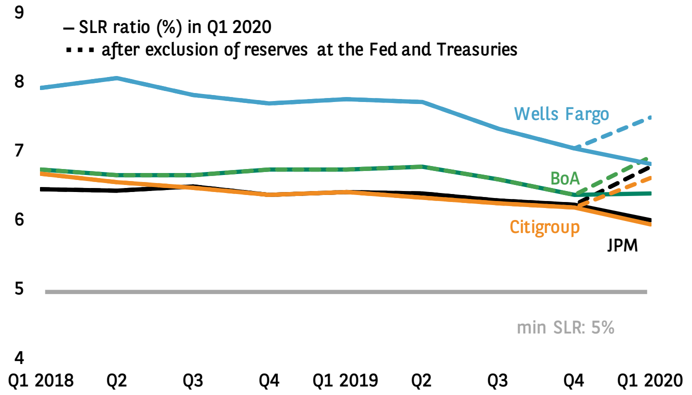


CHART 2

SOURCE: FFIEC 101, FR Y-9C, SNL, BNP PARIBAS CALCULATION

SLRS AT THE 4 BIGGEST DEPOSITORY INSTITUTIONS

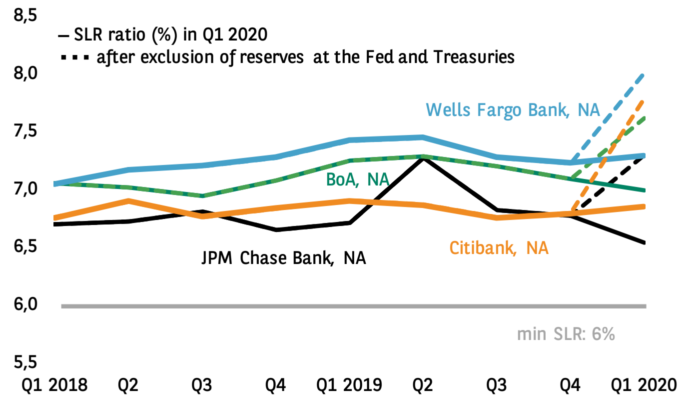


CHART 3

SOURCE: FFIEC CALL REPORTS, SNL,BNP PARIBAS CALCULATION

But there is little room for manoeuvre

For various reasons there are still strong constraints on the balance sheets of US banks: 1) the rule has only been relaxed on a temporary basis (to 31 March 2021); 2) some banks could be discouraged from using the relaxed calculation method as doing so would mean that dividend payments would be subject to approval from their supervisor;

19 Federal Reserve System (2020), Regulatory Capital Rule: Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio, Interim final rule, April 2020.
20 This will also apply for the calculation of total loss-absorbing capacity (TLAC) and the long-term debt (LTD) requirement.
21 Department of Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation (2020), Regulatory Capital Rule: Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio for Depository Institutions, Interim final rule, May 2020.
22 Only for those holding companies and depository institutions for which the leverage requirement is the most restrictive of the solvency requirements
23 Assuming that the growth in the Fed's balance sheet will be limited to public sector asset purchases and that these will stabilise at USD100 billion per month
24 These lines are not likely to be renewed given the relaxation of financial conditions on the repo, commercial paper and FX swap markets.

3) the rule explicitly neutralises the effect of this exclusion for the calculation of the G-SIB surcharge (in other words, the assessment of the systemic importance of a bank remains based on total exposure, including reserves at the Fed and Treasuries). Given the near-immutable nature[25] of the reserves created, unless the Fed markedly reduces the size of its balance sheet (which looks unlikely in the short term) regulators could be forced into a lengthy extension of the change in the calculation of the leverage ratio.

RESERVES ON THE REBOUND

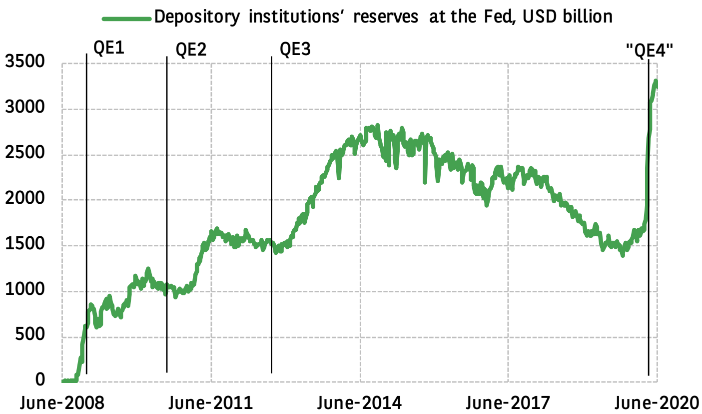


CHART 4

SOURCE : FEDERAL RESERVE (H.4.1)

COLLATERAL IS PROVING HARD TO DIGEST

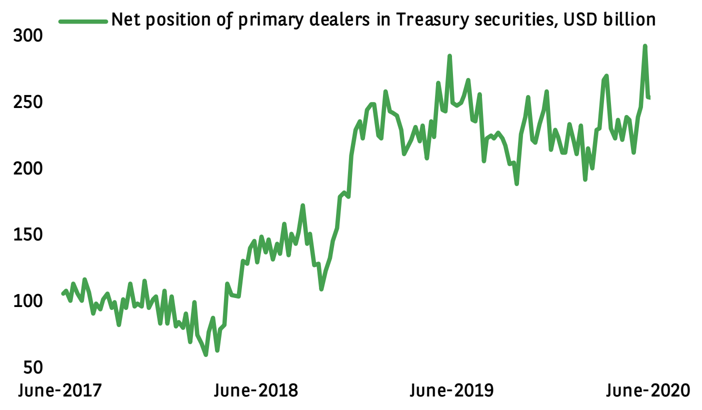


CHART 5

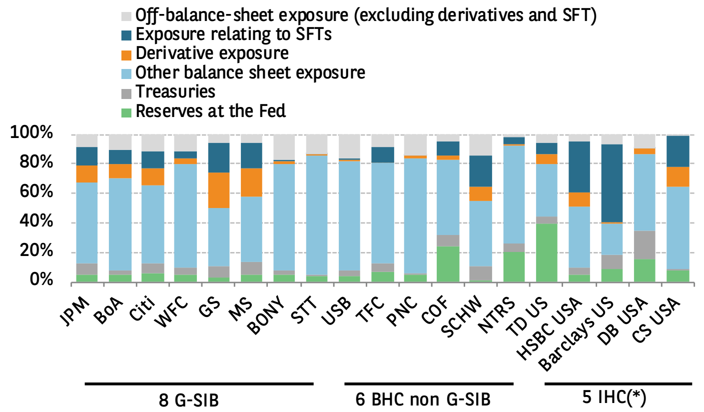
SOURCE: FEDERAL RESERVE OF NEW YORK

In addition, over the next few months, risk-weighted capital requirements are likely to become more crucial in assessing capital requirements due to an increase in credit risk and the introduction of the Stress Capital Buffer[26].

With repo, or without?

The terms of the second interim rule (issued on 15 May) raised questions about the treatment of Securities Financing Transactions (SFT: securities borrowing or lending transaction, repurchase agreements or reverse repurchase agreements; see Box). It is true that SFTs represent a non-negligible share of leverage exposure of certain major US banks (Chart 6). Their exclusions would also allow primary dealers to absorb more easily the abundant issuance expected from the Treasury: their balance sheets are growing not only because of the expansion of their inventories of securities, but also because of repo loans taken out to finance the former[27]. However, regulators have not formally excluded SFTs in either of the two interim rules[28]. The second rule merely stipulates that the total value of on-balance sheet Treasuries may be excluded from the leverage calculation whether or not they are used as collateral for financing and even where the transaction increased leverage[29].

BREAKDOWN OF LEVERAGE EXPOSURE



* UBS Americas Holdings breakdown not available

CHART 6

SOURCE: FFIEC 101, SNL

***

The current context provides further evidence, if it were needed, of the close links between the monetary and regulatory frameworks. Last September, the scarcity of reserves at the central bank, with regard to the liquidity requirements then in force, significantly perturbed the repo markets and forced the Fed to re-expand its balance sheet. Today, the abundance of reserves created by the various monetary support

25 Save for changes in autonomous factors
26 This rule, introduced by the Federal Reserve in April 2020, aims to simplify the regulatory framework by reducing the number of capital requirements that need to be satisfied. To achieve this, a Stress Capital Buffer has been introduced, the size of which, for each bank, will be fixed each year following CCAR stress tests.
27 Under a repo transaction, the borrower's liabilities increase by the amount borrowed under the repo, and its assets by the cash received. The security used as collateral remains on the balance sheet of the borrower (which retains its economic ownership).
28 When they issued the first rule, regulators explicitly raised the question of the opportunity to exclude SFTs from the calculation of leverage exposure, whilst in the second rule they raised the question of the specific type of SFT to be excluded.
29 The 15 May rule specifies that the exclusion of Treasuries also applies to securities "borrowed" (received) by the lending bank in a security-for-security repo-style transaction, even when they have been re-pledged as collateral in a SFT.

packages is forcing regulators to relax their leverage standards.The details of the relaxation of the Basel leverage constraints should not present any threat in terms of financial stability (only 'safe' assets are excluded from 'leverage exposure'). The temporary nature of the new arrangements, the retention of the calculation of the surcharge for systemically important banks and the possible increase in risk-weighted capital requirements[30] would appear to reduce the possibility that banks will increase their exposure to risky assets.

Over the next few months, risk-weighted capital requirements are moreover likely to be more crucial in assessing banks' capital requirements due to an increase in credit risk (economic crisis, the new Current Expected Credit Losses accounting rules on provisions) and the application of the Stress Capital Buffer[31].

Completed on 15 June 2020

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30 The introduction of the Stress Capital Buffer could result in a tightening of solvency requirements for the G-SIBs according to the Fed.
31 See Note 26.

ESTIMATED SLRS FOR HOLDING COMPANIES AFTER RELAXATION OF THE RULES

Q1 2020 data	Tier 1 capital, USD billion	Total leverage exposure, USD bn	Ratio SLR %	Improvement of SLR in basis points allowed by the exclusion of:		SLR after exclusion of reserves at the Fed and Treasuries, %	SLR requirement, %
				Reserves at the Fed(*)(**)	Treasuries portfolio(*)(***)		
JP Morgan (BHC)	213.4	3535.8	6.04	29	47	6.80	5.0
Bank of America (BHC)	191.5	2984.1	6.42	26	26	6.49	5.0
Citigroup (BHC)	154.3	2585.7	5.97	27	41	6.65	5.0
Wells Fargo (BHC)	154.3	2256.3	6.84	36	31	7.51	5.0
Goldman Sachs (BHC)	85.6	1438.9	5.95	23	58	6.77	5.0
Morgan Stanley (BHC)	73.9	1185.7	6.23	23	63	7.10	5.0
US Bancorp (BHC)	42.7	604.8	7.05	25	23	7.53	3.0
Truist Finnacial (BHC)	41.0	525.7	7.80	36	4	8.20	3.0
PNC Financial (BHC)	38.1	481.1	7.93	38	33	8.64	3.0
TD Group US (IHC)	37.4	445.8	8.39	65	56	9.61	3.0
Capital One (BHC)	41.5	440.1	9.42	33	9	9.84	3.0
Bank of New York Mellon (BHC)	21.9	392.8	5.58	145	55	7.58	5.0
HSBC North America (IHC)	19.6	367.1	5.35	5	59	5.99	3.0
Charles Schwab (BHC)	21.0	310.3	6.76	125	34	8.35	3.0
State Street (BHC)	14.6	270.3	5.40	190	33	7.63	5.0
Barclays US LLC (IHC)	16.9	213.0	7.95	47	42	8.85	3.0
DB USA Corp. (IHC)	14.2	152.7	9.31	101	103	11.35	3.0
Northern Trust (BHC)	10.0	138.3	7.24	140	27	8.91	3.0
Credit Suisse Holdings (IHC)	16.9	137.5	12.26	110	4	13.40	3.0
UBS Americas Holdings (IHC)	15.0	135.5	11.10	66	86	12.61	3.0
20 Holding Companies	1223.8	18601.6	6.58	37	41	7.36	
of which 8 G-SIB	909.5	14649.7	6.21	34	41	6.96	5.0
of which 6 BHC non G-SIB	194.2	2500.4	7.77	50	21	8.47	3.0
of which 6 IHCs	120.1	1451.6	8.27	49	62	9.39	3.0

BHC: Bank Holding Companies, IHC: Intermediate Holding Companies (US subsidiaries of foreign banks); G-SIB Global Systemically Important Banks; (*) average of data at 31 Dec 2019 and 31 March 2020; (**) including reserves at other OECD central banks for BONY and State Street; (***) sum of on-balance sheet Treasuries: held to maturity (HTM, at amortised cost), available for sale (AFS, at fair value) and held for trading purposes.

TABLE 1

SOURCE: FFIEC 101, FR Y-9C, SNL, BNP PARIBAS CALCULATIONS

ESTIMATED SLRS OF THE MAIN DEPOSITORY INSTITUTIONS AFTER RELAXATION OF THE RULES

Q1 2020 data	Tier 1 capital, USD bn	Total leverage exposure, USD bn	Ratio SLR %	Improvement of SLR in basis points allowed by the exclusion of:		SLR after exclusion of reserves at the Fed and Treasuries, %	SLR requirement, %
				Reserves at the Fed(*)	Treasuries portfolio(*)(**)		
JP Morgan Chase Bank, NA	204.7	3118.2	6.56	36	39	7.32	6.0
Bank of America, NA	153.1	2183.1	7.01	37	25	7.63	6.0
Wells Fargo Bank, NA	147.5	2017.5	7.31	42	29	8.03	6.0
Citibank, NA	136.9	1994.2	6.87	42	51	7.80	6.0
US Bank, NA	41.8	593.8	7.05	25	21	7.51	3.0
Truist Bank	39.6	507.7	7.80	37	4	8.21	3.0
PNC Bank, NA	31.7	469.3	6.75	33	29	7.37	3.0
Goldman Sachs Bank USA	29.8	425.7	6.99	87	90	8.76	6.0
The Bank of New York Mellon	20.4	326.8	6.24	187	244	8.34	6.0
State Street Bank	17.3	266.8	6.50	262	203	9.04	6.0
HSBC Bank USA, NA	20.3	254.9	7.97	50	90	9.37	3.0
Charles Schwab Bank	15.4	229.0	6.73	128	4	8.05	3.0
Morgan Stanley Bank, NA	16.8	192.4	8.75	135	144	11.54	6.0
Ally Bank	16.4	166.5	9.87	26	6	10.18	3.0
Capital One Bank, NA	17.4	149.8	11.63	18	7	11.89	3.0
Northern Trust Company	9.3	137.7	6.76	154	25	8.56	3.0
Barclays Bank Delaware	5.0	42.2	11.85	138	0	13.23	3.0
TD Bank USA, NA	3.0	25.8	11.47	607	117	18.71	3.0

(*) average of data at 31 Dec 2019 and 31 March 2020; (**) sum of on-balance sheet Treasuries: held to maturity (HTM, at amortised cost), available for sale (AFS, at fair value) and held for trading purposes.

TABLE 2

SOURCE: FFIEC CALL REPORTS, SNL, BNP PARIBAS CALCULATIONS

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