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Weakening Bank Capital Will Not Help the Treasury Market but Will Increase Financial Stability Risks

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There has been a lot of talk recently—by both leaders in the public and private sectors—about making changes to the supplementary leverage ratio ("SLR") which is a measure of banks' capital cushion relative to the overall size of their financial activities. The SLR is a key component of the framework of capital requirements for large banks, ensuring they have enough of a capital cushion to absorb a minimum amount of losses across all financial activities.

The proposed options include directly increasing the allowed leverage, excluding US Treasury securities ("Treasuries") from the requirement (which effectively would increase the allowed leverage), or a combination of both. These would seriously weaken the SLR and capital framework and increase financial stability risks.

The idea of modifying the SLR gained momentum after the "dash for cash" at the onset of the COVID-19 pandemic, during which so many Treasuries were being sold that the Federal Reserve ("Fed") stepped in to mitigate financial stability risks by purchasing $1.5 trillion of Treasuries in just over a month. Since then, the banking industry has used this event—and the April 2025 Treasury market volatility—as cover to support the proposed weakening of the SLR. The industry claims that if the suggested changes to the SLR were implemented, banks would have more freedom to intermediate robustly in the Treasury market during future stress events and mitigate any knock-on impacts that could harm the broader financial system.

In reality, weakening the SLR only would serve to lower capital requirements for the megabanks, increase their leverage, and make financial stability fallout from a crisis much worse. It would be a grossly negligent policy for the following reasons (detailed further below):

- First, the largest and most complex banks already have very high leverage, close to 18-to-1 in aggregate. That is as much leverage as the largest hedge funds. More leverage in the financial system, especially at banks, by definition increases financial stability risks.
- Second, the point of a leverage capital requirement is to ensure a minimum capital cushion to protect against losses across *all* assets. Any exemption of an asset type means it isn't a leverage requirement anymore and destroys its usefulness.

- Third, during the pandemic there was a temporary exclusion of Treasuries from the SLR, and Fed research shows that the exclusion had a negligible impact on banks' intermediation in Treasury markets.
- Fourth, as the Silicon Valley Bank implosion in 2023 demonstrates, all financial assets carry risk – including Treasuries – and so capital should be held against them to protect against that risk.

What is the Supplementary Leverage Ratio?

The SLR is one of the several capital requirements that apply to large banks. The difference is that all other capital requirements are based on the riskiness of specific financial activities in which a bank is engaged, whereas the SLR is concerned only with the overall size of a bank's combined financial activities regardless of risk. That is, the SLR is meant to be a single limit on amount of risk a bank can take across all its financial activities relative to its equity capital "skin in the game" or, put differently, it is a limit on how much of "other people's money" a bank can put at risk.

Large banks – those with more than $250 billion in assets – are required to maintain a ratio of 3% of capital to "total leverage exposure", which accounts for all financial activities of large banks, including so-called off balance sheet activities such as derivatives. That is the equivalent of around 30-to-1 leverage. But the largest, most complex banks like JP Morgan have an "enhanced" SLR requirement of 5%, equivalent to 20-to-1 leverage. For context, the largest hedge funds have around 18 to 20-to-1 leverage.

The SLR is meant to serve as a backstop to the risk-based requirements. That is, regulators generally agree that the riskiness of financial activities should be the primary determinant of how much capital a bank needs to protect against the risks of those activities, hence why there are risk-based requirements. So, the riskier an activity, the more a bank should use its own money to fund that activity and serve as a loss buffer to minimize or even prevent the losses from spilling over to external funding sources, such as depositors.

But regulators also recognize that there simply should be a limit on the overall level of leverage a bank can have, thereby serving as a backstop to risks that are not being captured effectively in the risk-based requirements. Put simply, risk-based requirements define the capital cushion to protect against a loss percentage for ***specific assets***, whereas the SLR defines the capital cushion to protect against a loss percentage across ***all assets***. This ensures there is a minimum capital cushion in case the risk-based cushion was calibrated too low.

Why Does the Banking Industry Want to Weaken the SLR?

Banks and their lobbyists say that the SLR is no longer serving as an effective backstop because the SLR has led to higher capital requirements than the risk-based methods for three out of the six largest bank holding companies, according to one of the industry's most prominent lobbying organizations. Their argument is that this mostly is due to large-scale government fiscal and monetary policy actions that have grown their balance sheets, events that are out of their control.

Moreover, banks claim that the SLR has limited the size of their balance sheet, preventing them from more robustly intermediating in Treasury markets.

Indeed, there have been incidents of turmoil in Treasury markets over the last few years, including the most recent episode in April 2025. Treasury markets are the foundation of our financial system and determine borrowing rates for everything from credit cards to mortgages to large international business transactions. And banks play an important role in these markets by being the dominant intermediary, but in March 2020 they pulled back from that role, requiring the Fed to step in.

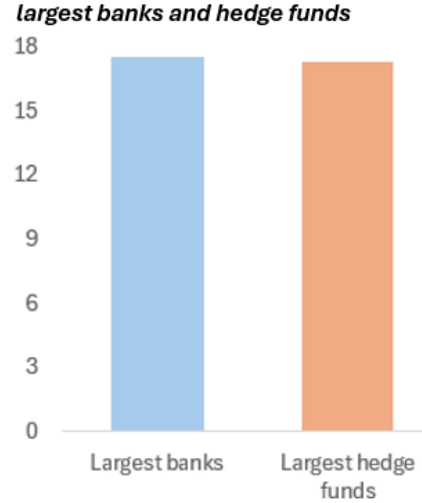
Banks argue that future market turmoil could be mitigated or prevented if Treasury securities were excluded from the SLR or if banks were allowed more leverage. Either way, the SLR would be weakened with these changes, and banks would be free to expand their balance sheets.

The reality, as always, is that banks want to have their cake and eat it too. Excluding Treasuries from the SLR would boost banks' return on equity by allowing them to earn huge amounts of additional interest income without having to add to their equity capital. Moreover, increasing leverage would allow banks to engage in ever-riskier activities without commensurate increases in capital. However, there is no such thing as a free lunch; if banks are not held accountable for protecting themselves against the risk of their activities with capital, then as with the 2008 Crash the cost of huge losses are shifted to taxpayers.

Allowing Banks More Leverage Would Greatly Increase Financial Stability Risks

The largest banks already have very high levels of leverage, nearly 18-to-1, which is as much leverage as the largest hedge funds (see figure). That's because most of the largest banks keep their SLR close to the 5% requirement, which is a dollar of capital funding for every 20 dollars of external funding. The banking industry does not want to publicize this fact and instead focuses their messaging on their risk-based capital ratios, which are much more difficult to understand and interpret.

Figure 1: Leverage levels of the largest banks and hedge funds



Source: Federal Reserve's FR Y-9C and Office of Financial Research's Hedge Fund Monitor

Limits simply must be in place for the overall leverage of banks. That premise should not be questioned because banks' risk puts depositors and taxpayers at risk. High levels of leverage can be very problematic because, as noted above, leverage essentially is a representation of how much the banks owe to others – such as depositors – relative to how much they have invested themselves.

Put differently, the largest banks use nearly 18 times more of "other people's money" than their own to invest in financial activities, which means a loss only of around 5.5% would make a bank insolvent and unable to pay back others. For context, 10-year Treasuries experienced a 5% decline over just a five-day period this April. And losses beyond that amount would spill over to depositors and, because the largest banks are so interconnected throughout the financial system, to other banks and financial institutions.

As leverage increases to even higher levels, even smaller losses would lead to bank failures, bailouts, and economic turmoil and devastation, as with the 2008 Crash. This is exactly what excluding Treasuries, raising the maximum leverage, or some combination of these options would do – increase leverage to much higher levels.

The industry says that the SLR is not a backstop to the risk-based requirements as it is supposed to be because it is higher than risk-based requirements for multiple of the largest banks. But the answer to the SLR being the highest capital requirement is not to raise the amount of leverage as the industry wants. If anything, it is an indication that the risk-based requirements should be strengthened.

Exclusions to the Leverage Requirement Defeat the Purpose of the Requirement

A leverage-based capital requirement like the SLR is simple and not risk-based for a very specific reason—the overall leverage of a bank should be limited. That is because even if the financial activities are low risk, higher and higher leverage means lower and lower loss amounts that would result in the bank's insolvency. For example, a bank with leverage of 10-to-1 could withstand a 10% loss across all financial activities with its own capital investment, whereas a bank with leverage of 20-to-1 could only withstand a loss of only 5% with its own capital investment.

Excluding Treasuries from the SLR would mean it is no longer a leverage requirement, therefore undervaluing a bank's capacity to protect itself against loss. Such an exclusion effectively would turn the SLR from a true leverage requirement into a sort of risk-based requirement in which all assets are assumed to have equal risk, except Treasuries, which are assumed to have zero risk which simply is not the case (more below). Furthermore, making this change would not actually change the true leverage of the bank. Losses are losses, and if a bank does not have enough capital to withstand those losses, it will fail.

For example, JP Morgan currently has about 16.5-to-1 leverage, but excluding Treasury activities would make it look like 14.5-to-1. And if JP Morgan decided to double its Treasury holdings, its real leverage would be 18-to-1 while the SLR would remain at 14.5-to-1. So, in reality, JP Morgan would be able to withstand only a 5.5% loss even though its SLR would imply a nearly 7% loss cushion.

The alternative suggestion of softening the requirement to allow more leverage also obviously would increase leverage, resulting in the same consequences.

Exemption of Treasury Securities Would Not Result in Additional Intermediation by Banks but Rather Would Create Perverse Incentives and Crowd Out Lending

Even though banks claim that exemption of Treasury securities from the SLR would allow them to intermediate more in periods of stress, research from the Federal Reserve clearly shows that would not be the case and highlights two important points.

First, Treasury activities that occur at banks' broker-dealers – the subsidiaries that actually engage in market intermediation – are a small proportion of the overall SLR requirement relative to other financial activities. That is, since market intermediation is a small fraction of the SLR requirement, it is not a limiting factor for banks to increase that intermediation during stress periods as they claim.

Second, we don't have to guess that banks won't increase their intermediation if Treasuries are excluded, we can look at the reality of their actions. Treasury securities in fact were excluded from the SLR for ten months during the pandemic for the very purpose of promoting their intermediation in Treasury markets. But that same research shows there was a negligible effect on bank intermediation, i.e., they did not increase their intermediation as they claim they would.

So, as with the temporary exclusion during the pandemic, a permanent exclusion simply would not increase bank intermediation through their broker dealers but rather simply would increase their holdings of Treasury securities at their depository institutions. And since depository institutions primarily use deposits to fund financial activities, if more of those deposits are going towards Treasuries, then fewer deposits would go to lending.

Treasury Activities Have Risk

Banks argue that Treasury activities have very little risk, and so the exemption would not be materially detrimental to their safety and soundness. While it is true Treasury activities generally have low risk, like other assets they have a risk of taking losses on their market value that can be (and have been) material. Such losses must be mitigated through bank capital. This was made very apparent in 2023 when the Fed's rapid and large-scale rate increases resulted in heavy market losses on banks' holdings of securities, including Treasuries. These heavy losses pushed multiple banks towards insolvency, scaring depositors and resulting in bank runs and failures, most notably at Silicon Valley Bank.

Market losses can be very meaningful for a bank with high leverage. For example, if a bank only holds Treasury securities and has 20-to-1 leverage, then only a 5% decline in the market value of those Treasury securities would make the bank insolvent. For context, 10-year Treasuries experienced a 5% decline over just a five-day period this April.

A common point made by banks and their lobbyists is that Treasury activities have a zero risk weight under the risk-based capital requirements, and so even the regulatory agencies recognize the low risk profile. On the contrary, although Treasuries are assigned a zero risk weight for credit risk, there is a risk weight for their market risk, the very risk that contributed to bank failures in 2023. Furthermore, market risk losses also are captured in the stress test-based capital requirements. That being said, even these risk-based requirements for Treasuries likely are too low.

Conclusion

Changes to weaken the SLR do not reduce financial stability risks—as the industry states—but rather would significantly increase risks. The reality is exactly the opposite of the industry's claims—huge potential costs to financial stability and zero potential benefit. Put simply, changing the SLR would not increase Treasury market intermediation by banks, and higher leverage at banks would greatly increase the probability of bank failure, taxpayer bailouts, and financial and economic devastation.

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