US Rates Strategy

Joseph Abate, US Rates Strategy, joseph.abate@smbcnikko-si.com 1 212 893-1592

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Higher leverage and no haircut

The buildup of financial market leverage has been a key regulatory concern since the financial crisis. This was reiterated in the July FOMC minutes. Leverage can build up if dealers do not collect haircuts on their secured lending. But how prevalent is no haircut repo?

- The July FOMC minutes highlighted the financial stability risk posed by financial sector leverage. "Vulnerabilities associated with leverage in the financial sectors were characterized as notable."[1]

- **Several studies note that approximately 70% of Treasury repo trades have zero (or negative) haircuts**. But the absence of a haircut does not mean dealer and their clients are unprotected against counterparty risk.

- A closer examination of the zero-haircut repo suggests that much of it is part of packages where the counterparty exposure nets down. And, perhaps as much as half is between affiliates of the *same* firm.

- Similarly, a portion of the unhaircutted repo trades likely reflects other techniques for reducing counterparty risk including position limits and cross-product margining.

- In theory, the SEC's central clearing mandate should eliminate unhaircutted transactions. **But in practice, the direct member frequently fully funds its clients' margin.** We expect this to decline with the development of alternative access models and an expansion in cross product margining.

Leverage build-up

In the July FOMC minutes the Fed outlined some of the financial stability risks it sees. In addition to market valuations and tight credit spreads, it cited the "vulnerabilities" from financial sector leverage. The Minutes also pointed out that "leverage and rollover risks at hedge funds remained high and concentrated at the largest firms". Indeed, repo borrowing at the ten largest hedge funds by gross asset values has more than doubled since 2019 (Figure 1). And the leverage associated with some types of hedge fund strategies has increased since 2022 (Figure 2).

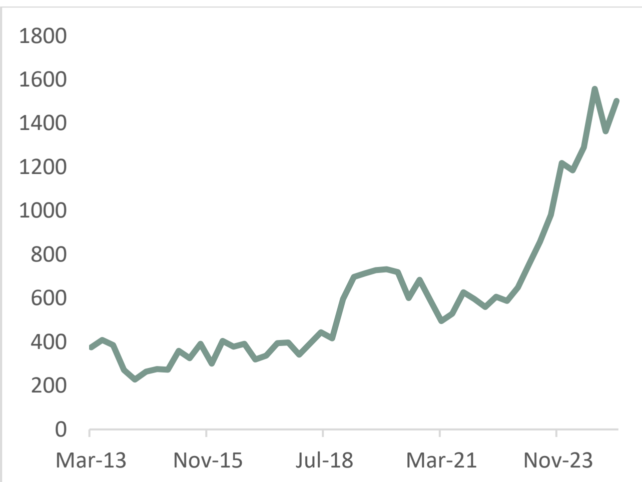
Zero haircuts

Hedge fund leverage is attracting more regulatory scrutiny since 2020 for two reasons. First, regulators were surprised to discover the prevalence of unhaircutted repo transactions in the market. These allow the creation of sizeable amounts of leverage in the Treasury market. They occur in the non-centrally cleared bilateral repo (NCCBR) market. Historically, this market has been relatively opaque as

[1] See, FOMC Minutes, July 29-30, 2025, Federal Reserve.

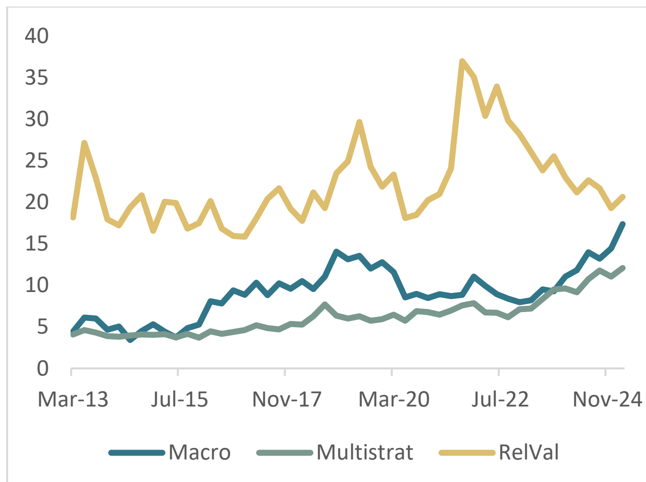
transactions are typically negotiated on a bespoke basis between counterparties. In addition to the standard trade terms such as price, quantity and tenor, dealers and their clients frequently negotiate the haircuts to be applied. **Using data from a pilot study of the NCCBR market, the Office of Financial Research found that 74% (by volume) of the Treasury repo trades reported had no haircut** (Figure 3).[2] A separate study using a data on large hedge funds' financing data found that a similar amount of their Treasury repo trades had no (and even negative) haircuts.[3] In the largely uncleared tri-party repo market, the median haircut against Treasury collateral has been 2% for over 15y although the incidence of smaller margins has increased since 2022 (Figure 4). That said, regulators were unsettled to learn that this key component of prudent counterparty risk management was so low. Some dealers appear to be in competition with each other to offer the lightest haircuts.[4]

Figure 1: Top 10 hedge fund repo ($bn)



Note: Repo is against all collateral types. Source: SEC, SMBC Nikko

Figure 2: Hedge fund gross to net asset values



Source: SEC, SMBC Nikko

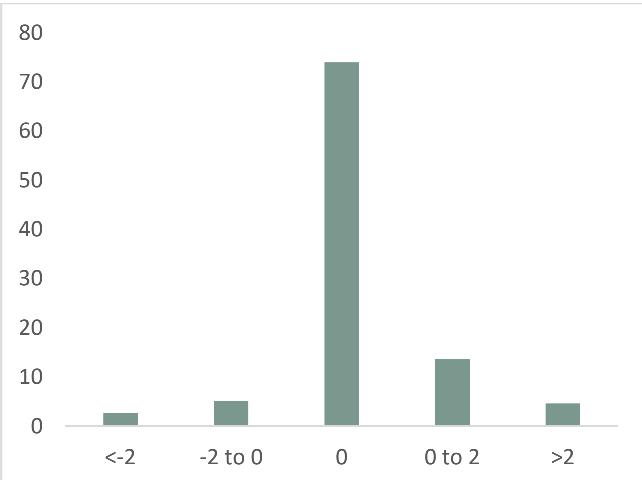
Second, there has been an increase in relative value trading by hedge funds over the past few years. One type of relative value trade appears to be attracting the most regulatory scrutiny - the Treasury cash futures basis trade. The investor is long a Treasury security and simultaneously short a Treasury future. These trades often require large amounts of leverage to generate respectable returns. This activity picked up ahead of the September 2019 repo spike and position unwinding early in 2020 exacerbated the illiquidity in the Treasury cash market caused by other sellers. Relative value trading has once again increased although measuring the actual volume is difficult.[5] **Coupled with the surprisingly high incidence of unhaircutted transactions regulators have grown concerned about a potentially destabilizing buildup in financial market leverage**.

[2] Hempel et al. (2023).
[3] See, "Hedge fund Treasury Exposures, Repo, and Margining", A. Banegas, and P. Monin, Federal Reserve Board, September 8, 2023.
[4] See, "Non-Centrally Cleared Bilateral Repo and Indirect Clearing in the US Treasury Market: Focus on Margining Practices", Treasury Market Practices Group White Paper, May 2025.
[5] See, "Quantifying Treasury Cash-Future Basis Trades", J. Glicoes, B. Iorio, and L. Petrasek, Federal Reserve Board, March 8, 2024.

A closer look at unhaircutted repo

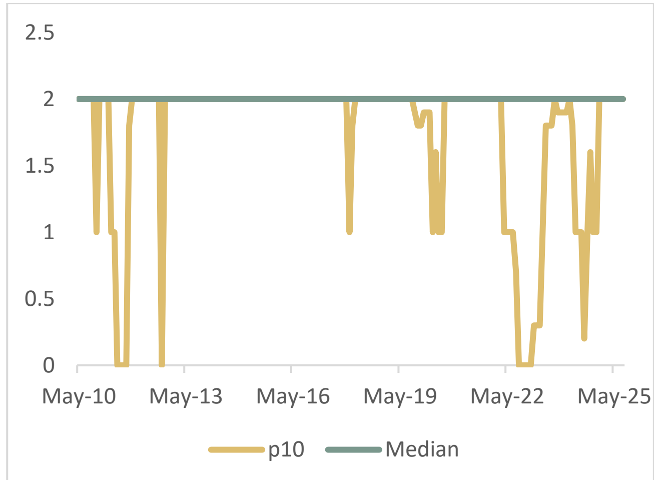
The absence of a haircut does not mean dealers and their clients are unprotected against counterparty risk. Moreover, the prevalence of unhaircutted repo transactions may be overstating systemic risk.

Figure 3: Treasury haircut distribution (% NCCBR)



Source: Hempel et al., SMBC Nikko

Figure 4: Treasury tri-party haircuts (%)



Note: p10 are the haircut applied to the lowest 10% of the distribution.
Source: Federal Reserve Bank of New York, SMBC Nikko

First, there are other ways to reduce counterparty risk besides collecting a haircut. For instance, dealers might apply position limits to their clients' trades. Similarly, some of unhaircutted repo trades are part of packages where the client is both long and short. Netting these trades reduces the counterparty exposures facing the dealer and client. **Indeed, Hempel et al. found that some 60% of the zero haircut Treasury repo trades they identified in the 2022 NCCBR pilot study were part of packages with naturally offsetting exposures**. The authors argue that much of the remaining unhaircutted Treasury repo activity in NCCBR is likely part of some portfolio margining arrangement where the dealer is collecting margin in aggregate across different trades, positions, and markets.

Second, some of this unhaircutted activity is internal. Cenicola notes that perhaps as much as half of zero haircut Treasury repo is between affiliates of the *same* institution. Friedrichs et al. identified about \$215bn/day in interaffiliate repo – about 10% of the NCCBR market in 2024.[6] Interaffiliate repo tends to be settled in tri-party and the individual transactions sizes tend to be larger than those with outside counterparties. Much of this activity is related to large banks' internal liquidity management – for example, shifting liquid resources across different branches and units. Interestingly, interaffiliate repo activity rose to around \$300bn/day in late 2024 with much of the new volume occurring at rates as much as 100bp below SOFR. Until recently, it was unclear if these transactions would need to be cleared. However, the SEC decided to exclude interaffiliate repo trades provided the affiliate submits all its other eligible repo trades for clearing. Note that interaffiliate repo is excluded from the calculation of the Fed's benchmark repo rates.

[6] See, "Affiliate Repo and the 2024 Short-term Funding Monitor Update", M. Friedrichs, R. Mann, L. Olson, and K. Potapov, US Treasury Office of Financial Research, August 2025.

Central clearing

In theory, the SEC's central clearing mandate should eliminate unhaircutted transactions. After all, these transactions would all be subject to the FICC's VaR margining rules. Likewise, the trades would subject to the FICC's additional fees that reflect the illiquidity of the member's positions and the increase in Treasury market volatility since 2023.

But, even with the clearing mandate, not all repo trades will have to be centrally cleared. In addition to the affiliate transactions described above, trades that do not have a specific end date (for example, on open trades) are not covered. Whether the FICC will be able to clear these transactions in the future is unknown.

The SEC requires the FICC to collect margin which it calculates (and collects) twice a day.[7] Significantly, it does not specify *who* ultimately pays the margin – the direct member or its indirect, sponsored client. **In practice, the direct member frequently fully funds its clients' margin**. The TMPG notes that this may not be prudent risk management or practical once the market is fully cleared. But while it is not recommending specific changes to the practice or the application of minimum haircuts on uncleared transactions, it is asking dealers to take a closer look at their risk management practices in both markets.

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[7] And more frequently in periods of market stress.

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