US Rates Watch

UST leverage on the chopping block

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Official sector increasing focus on UST leverage

The official sector has increased focus on leverage usage in the Treasury market. US regulators see elevated UST leverage as a source of financial stability risk. The focus comes amidst increased discussion around central clearing in the Treasury cash & repo markets + market repo haircut standardization. Official sector moves to curb leverage or increase haircuts could see USTs cheapen vs swaps, esp as supply grows. Lower leverage may reduce stability risks but could increase illiquidity which translates into higher costs to the taxpayer. Lower leverage usage may also not help in crisis periods. Official sector appears motivated to finds ways to reduce overall leverage usage.

Fed focus on hedge fund Treasury leverage has increased

The Fed published two reports in quick succession on hedge funds increasing usage of repo and futures, starting August 30th.[1] We doubt the Fed intended the timing of these notes as a specific policy signal, but they demonstrate concern about risks stemming from hedge fund leverage in the Treasury market. The Fed's concern is summarized here:

"Hedge funds have become among the most active participants in U.S. Treasury markets over the past decade. As a result, the financial stability vulnerabilities associated with their leveraged Treasury market exposures, which are facilitated by low or zero haircuts on their Treasury repo borrowing, have become more prominent".

Piecemeal solutions for UST market abound…

Fed concern over hedge fund leverage in the Treasury market fit within the broader concern over UST structure and functioning post March 2020. Several threads are now being explored to improve the resilience of Treasury markets under stress; these include expanded clearing and reporting, increased regulation of hedge funds, increased costs of leverage, all-to-all trading, and changes to bank regulation. We think each of these steps do not solve the underlying issue of elevated UST supply and limited risk-appetite to intermediate large risk transfers at the dealer level.

…. broader solutions necessary but likely unpalatable

More comprehensive approaches are likely necessary. These include changing bank capital requirements to improve Treasury dealer capacity, formalizing the role of the Fed to maintain market liquidity or some other buyer of last resort, and a reworking of the banking laws to define the role of dealers as risk absorbers. However, these approaches are likely unpalatable for the official sector since they involve regulatory easing or a more permanent role for the Fed in the Treasury market. Without a comprehensive solution, further UST liquidity and market function challenges seem inevitable.

[1] "Recent Developments in Hedge Funds' Treasury Futures and Repo Positions: is the Basis Trade "Back"?" Aug 30, 2023 & "Hedge Fund Treasury Exposures, Repo, and Margining" Sep 8, 2023

Background on official sector UST leverage concern

Official sector concern around Treasury market functioning have been building for years but materially accelerated after March 2020. Recall, in March 2020 the Fed bought $2tn Treasuries over 6 months in an ad-hoc market intervention to maintain functioning. This was a historically large & rapid Fed intervention in the Treasury market taken, in part, to facilitate a de-risking of highly leveraged hedge fund UST positions, but also to absorb Treasury sales from foreign officials and others.

Since March 2020, the official sector has taken a multi-pronged approach to addressing Treasury market fragility. These steps include:

- Improved Treasury market transparency
- FSOC mandate to better understand and monitor the distribution of leverage across the financial system, where concentrations may create vulnerabilities.
- SEC effort to transition the repo market into a fully cleared market – where the Fixed Income Clearing Corp would act as counterparty to the majority of repo positions outstanding. For more detail on the SEC clearing proposal see SEC clearing: higher cost, marginal benefit.

We think each of these steps do not solve the underlying issue of limited ability for the dealer community to intermediate risk within a context of rising UST supply, which the Group of 30 flagged as the key problem. These constraints have led to a Treasury market that increasingly relies on hedge fund leverage to maintain relative value relationships amongst Treasury cash bonds, futures and swaps.

FSOC range the bell in April on Treasury leverage

In April 2023, Treasury Secretary Yellen released a series of proposals that represented in our view a major step towards regulation of non-bank financial companies, including hedge funds. The 2 recent Fed reports we view as part of this new FSOC initiative, and we expect more studies and recommendations to come. The April FSOC announcement included authorization for FOSC to designate a nonbank financial company for Federal Reserve supervision and prudential standards.

The FSOC move was in part a reaction to the events of the banking sector events of March 2023, but was a culmination of efforts since the 2014 Treasury yield "flash crash" to regulate nonbanks. Regulation of nonbanks has been a top priority for the Financial Stability Board (FSB), which is a global entity that monitors systemic risks and recommends solutions. All of the major countries are part of the FSB, including the US which is represented by Fed Governor Michael Barr, Treasury Undersecretary Nellie Liang and SEC Chair Gary Gensler.

Leverage and repo the immediate focus

Recent Fed papers make clear the issue at hand: hedge fund Treasury market leverage. The Fed papers discussed the possibility that increased futures-cash basis trading activity occurring within hedge funds is a potential source of market instability. The futures-cash basis was a component of the market dislocation back in March 2023, but we do not see it as more risky than other relative value trading strategies.

In this context, we found two key data points striking from the recent Fed pieces:

- Fed piece on basis positions suggests regulators do not know what trades are being done, basis or otherwise, at hedge funds. In our view this was the more revealing aspect of the basis piece, i.e. that regulators are still far from understanding market risks held by major investors and therefore may need more information before creating robust ways to address the issue. Increased hedge fund reporting & oversight seems inevitable to understand these risks.

- Fed piece on hedge fund repo use noted that 50 funds out of more than 2000 account for 83 percent of qualifying hedge funds' UST exposure and 89 percent of repo borrowing (qualifying HF = $500mm+ in assets). This reveals a high concentration of UST repo borrowing & leverage.

These takeaways suggest that the official sector is likely to increase oversight of the hedge funds with the largest & most concentrated leverage positions. This will likely eventually result in constraints on risk taking or higher haircuts to ensure additional capital to absorb potential losses on hedge fund futures-cash or other relative value trading strategies.

Target on hedge fund back: changes & potential impact

We expect regulators to increase the cost of leverage and reduce its concentration. Increased costs would likely come from 1) higher repo haircuts (the amount of securities that are not funded in repo and must be funded by the investor at a higher market cost), and 2) mandated repo clearing phased in slowly over time. In addition, we eventually may see limits on market concentration, which would presumably limit the total share of repo markets used by any single firm.

The ultimate aim of reducing leverage concentration and increasing the cost of leverage would be to improve market resilience by 1) reducing unwind risk, or fire sales, of Treasuries by hedge funds in crisis events, and 2) increasing dealer balance sheet capacity via increased repo netting to accommodate large liquidations and fire sales.

While it is still early days on these regulatory threads, we think these changes in repo markets and increased regulation of hedge funds will not likely help dramatically, if at all. In fact, we can imagine a new world in which Treasury markets have fewer participants policing dislocations, ongoing concentration amongst existing participants, & higher costs to trade the dislocations. This implies that relative value opportunities would be larger for the fewer remaining hedge funds to take advantage of and would be more costly to execute and carry. Large dislocations could attract the same types of trades within the remaining leveraged funds which could increase systemic risks of any single counterparty failure.

The Fed estimates in their repo piece that if repo haircuts were raised 2%, so that at least 2% of a Treasury position would need to be financed outside of the repo market, the leverage gearing would be cut in half, which would imply that relative value opportunities would need to be twice as large to produce the same return on equity. This doesn't account for the potentially wider bid/offer spreads in the repo market which would make the hurdle rates even higher for relative value trading. Treasuries would also likely need to cheapen versus swaps in a world with lower leverage & higher haircuts, raising the relative cost of Treasury debt versus Fed policy expectations.

While the benefits of these types of limitations might reduce risk of a financial crisis driven by hedge funds, it could come at a cost of lower overall Treasury market liquidity in normal times and reduced participation in the eventual all-to-all trading model that regulators are considering. These changes would also likely result in higher costs to the taxpayer via increased Treasury dislocations & modestly higher UST rates, all else equal.

Clearing timeframe: runway needed to ensure no harm

There is chatter that a final SEC clearing final rule could come this year. We can't rule this out but hope the official sector takes more time to fully assess costs & benefits of the clearing proposal. We worry a hurried push for Treasury clearing may do more harm than good.

The last comment we saw on the SEC repo proposal was delivered on Sep 1, 2023. The SEC will need to read all the comments and prepare responses. Treasury market structure and resilience are complex and are only recently getting more attention and study. The Fed does not even know at this moment the size & location of basis trades.

We think regulators will want to learn as much as they can about all the potential solutions before making major market changes.

We do not think the presidential election calendar matters for the SEC's clearing proposal because 1) Chair Gensler's term expires in 2026, and 2) the SEC needs to get it right, rather than do it fast. The Administrative Procedures Act is important for this and gives stakeholders rights to question the process if it moves too fast or without thorough analysis.

The Treasury market is too systemically important to act quickly without detailed cost/benefit analysis and detailed input from all stakeholders at each step of the way. We see this as a multi-year effort and would not be surprised if any major changes were not finalized in 2024 or even 2025, but chatter is rising for a 2023 final rule. Once finalized, we would also expect long phase-in periods to study impacts along the way and give markets plenty of time to adapt. Market impacts from cliff-like changes in repo haircuts or clearing requirements we think could cause great disruptions to Treasury markets that could require a new set of measures to address and create delays and difficulties for proper reforms.

The official sector needs to tread carefully in large scale reforms of Treasury market functioning. The core issue plaguing the Treasury market: too much debt, dealer regulatory constraints, and limited appetite to intermediate risk. The official sector should adhere to the core principle: do no harm. Piecemeal solutions around clearing, hedge fund oversight, & all-to-all trading do not fundamentally address the root issues and should move carefully. Broader solutions that expand dealer capacity or formalize the Fed backstop role should be more seriously considered, even though they may be harder to stomach. A recent paper by Lev Menand (Columbia Law School) and Josh Younger (NY Fed) suggest a way to increase the capacity and appetite of Treasury dealers while keeping them within the regulated bank realm. Darrell Duffie (Stanford Business School) and Frank Keane (NY Fed) suggest making the Fed's market-operation role (as we saw in April 2020) more explicit. We have also suggested ways to implement a dealer of last resort (see Treasury liquidity needs stronger solutions 07 September 2022).

Bottom line: Steps are underway to limit the role of hedge funds leverage in the Treasury market via central clearing & higher haircuts. These changes will likely reduce liquidity, concentrate trading strategies within the hedge fund industry, & cheapen USTs vs Fed policy swap rates. We envision a relatively long lead time to finalize these rules. A more rapid rule implementation cannot be ruled out but rushed implementation risks larger & deeper disruptions.

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