US Rates Watch

Increasing focus on leverage and haircuts

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Rates Research
United States

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

US Rates Research
BofAS
+1 646 855 8846

See Team Page for List of Analysts

Leverage landscape transitioning

Stakeholders in financial system oversight last week indicated a renewed focus on reducing leverage in the repo system potentially by fast-tracking minimum repo haircuts. Instead of waiting to finalize and implement the more complex SEC repo clearing proposal, regulators might decide to make changes more quickly at the dealer level, via the bank holding companies, on restrictions for minimum repo haircuts which the Fed reports is currently 0% (no excess collateral) for most large hedge funds. According to financial news reports, early-stage planning is already underway looking at options for reducing leverage usage by regulating dealers who stand on both sides of the repo borrowing/lending business.

Treasury conference Nov 16 closely watched

Consensus expects a final repo clearing rule to be released by the SEC around the same time as this year's annual Treasury Market Conference on Nov 16th. The SEC repo clearing rule was proposed back in Sept 2022 and has been open for comments and supplemental comments since then, with comments received as recently as last week. We think that the ongoing review of these comments and preparation of a full cost/benefit analysis will make it difficult for the SEC to release a final rule in time for the conference next month. But whether it comes in Nov or next year, SEC is moving forward with a repo clearing mandate and we would not be surprised to see a rule finalized next year, if it happens at all. If haircuts are regulated separately and the desired deleveraging is achieved, it is also possible that repo clearing does not become mandated at all.

RV- relative value

FSOC also on the move

The FSOC (Financial Stability Oversight Council) took a major step in April 2023 to increase their ability to designate a nonbank, including a hedge fund, for regulatory oversight by the Fed. Recent reports suggest that the FSOC has recently formed a hedge fund working group which could be looking at options to reduce leverage and possibly also at designations of systemically important entities. We do not know whether the initial proposals will involve only repos with hedge funds or will include other account types, but would expect the regulation of haircuts to potentially develop over time. The usage of futures has increased recently with total open interest at new highs across different futures benchmark maturities. This open interest has particularly caught the Fed's attention because CFTC data shows positions have become historically concentrated in asset manager longs vs leveraged fund shorts. While asset managers and leveraged funds are traditionally net long and net short in a mirror image, the increase in concentration of positioning in the past 2 years has been viewed as a growing risk.

Where do we go from here

We think that it is possible for regulators to increase haircuts and reporting requirements within a 6-month time frame. Because of the currently heightened systemic risk level, these kind of rule changes would not need as lengthy a public discourse as something like a repo clearing mandate rule, which would impact many entities, not just dealers, in making significant changes requiring possibly years of logistics. We think the Nov 16 Treasury Market Conference at the Fed next month might provide additional commentary from regulators around this fast-track option. We suspect that it will not be pitched as a substitute for the clearing mandate, but rather as an add-on. With the recent phase of high market volatility beginning in 2020, we think regulators will be looking for "low hanging fruit" opportunities to reduce overall systemic risk. The risk generated by excessive leverage is unwind risk, ie fire sales, which have been seen throughout the decades, but with the Treasury market now large compared to dealer appetite/capacity, near term action seems more likely in our view. We expect minimum haircuts could be in the range of 2% or maybe lower, and could depend on the maturity of the underlying Treasury collateral security as well as on counterparty metrics such as overall leverage gearing or total asset size/complexity etc.

Market impact – tighter swap spreads, larger RV

An increase in haircuts ultimately translates into a higher cost of leverage. We think this would impact smaller funds more than the larger ones, which could result in some consolidation within the hedge fund sector. With lower leverage gearing, relative value trades would generally need to offer greater return opportunities compared to today to entice funds to engage in them at a higher capital cost. This would imply greater dislocations before attracting capital, which would span rate markets including Treasury and swaps yield curves, off-the-runs versus on-the-runs, the implied volatility grid, futures vs cash, swap spreads, and cross market relative value trades. We would expect higher leverage costs to possibly result in wider bid/offer spreads in repo markets. In a report from September, the Fed estimated that a blanket 2% haircut in repo markets could require double the relative value dislocations to offset the higher costs to trade. We are already negative on swaps spreads due to rapidly increasing supply and tightening regulations, and would strengthen conviction in this outlook if haircuts are increased. In addition, we would expect an overall decrease in rates market liquidity as potentially fewer traders participate given higher costs of entry. Haircuts directly enter into the risk-weighted exposure calculation for repo trades, and so a positive outcome of higher haircuts could be a reduction in total risk-weighted exposures for dealers.

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Research Analysts

US

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Katie Craig
Rates Strategist
BofAS
+1 646 855 6625
katie.craig@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Anna (Caiyi) Zhang
Rates Strategist
BofAS
+1 917 826 5142
caiyi.zhang@bofa.com