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# The negative-haircut repo market phenomenon

Reverse clickbait alert




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In all the excitement about Jane Street and subsequent holidays we forgot to read the latest working paper published by the European Central Bank. We finally got around to it, and it turns out it's a page-turner on the repo market.

Really! Here's the synopsis, with Alphaville's emphasis in bold below:

> Our paper documents five key facts: (1) US dollar repos by euro area entities account for approximately 40% of total volumes and are comparable in size to euro repos; (2) term repos (with maturities beyond one day) are quantitatively more relevant than commonly thought, especially non-centrally cleared ones; (3) repo markets have become more collateral-driven, involving diverse nonbank financial players and trading motives; (4) banks' intragroup transactions form a large share of non-centrally cleared volumes; and **(5) haircuts, even for riskier collateral, are often zero or negative, especially in euro trades.**

Wait what?

As a reminder, repurchases — or repos — are short-term collateralised loans, typically extended by money market funds and other financial institutions with a lot of surplus cash. The borrower is usually an investment fund of some kind that wants to finance a trade.

Here's how it works. Say Alphaville is in need of some short-term financing for a quick punt on MSTR's latest cash grab. We could sell $10mn of a Treasury bond we keep for such occasions and agree to buy it back for $10.01mn tomorrow. The slightly higher repurchase price is the de facto interest we'd pay for the overnight loan.

Generally speaking, the better the collateral the more you can borrow against it. While the "haircut" on a loan collateralised by US Treasuries might be minimal — for $10mn of Treasuries we can borrow $9.99mn — we might only be able to borrow 80-90 per cent of the value of a corporate bond.

However, the three authors — Felix Hermes, Maik Schmeling and Andreas Schrimpf — show that 9 per cent of all euro-denominated repo trades and 4 per cent of dollar ones are now done with a *negative* haircut — in other words, you can borrow more than the collateral you put up:

> This negative haircut phenomenon suggests that the conventional view that haircuts primarily serve as a risk management tool for the cash lender may warrant reconsideration. Instead, our results suggest that negative haircuts arise from three main sources.
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> First, since haircuts are endogenously set in bilateral transactions, they reflect market power, where certain institutions can negotiate better terms due to their stronger bargaining position.
>
> Second, negative haircuts indicate a high demand for specific securities. Receiving a particular type of collateral may be so valuable for certain players that they accept that their cash lending is not fully covered by the collateral value.
>
> Third, negative haircuts are more prevalent in internal capital markets, where banking groups use negative haircuts to move funding between their members.

The last of these is the most meaningful issue in Europe. Internal repo is when two entities that belong to the same overarching company engage in a bilateral repo transaction — for example when the commercial banking arm of BNP Paribas lends money to its own investment banking arm.

Intragroup repo account for approximately €700bn of outstanding volumes in euro transactions, and $350bn in dollar transactions, according to the ECB paper. And almost 30 per cent of euro-denominated intragroup repo transactions feature negative haircuts. After all, if one arm of the bank is de facto lending to another, you're probably not overly fussed with under-collateralisation.

However, as Hermes, Schmeling and Schrimpf note, negative haircuts persist even if you remove intragroup repo from the equation. So this is only a partial answer to the question of why they are surprisingly prevalent.

We wonder if the second point they raise — ie, "high demand for specific securities" — is just as influential, at least in the US.

Very occasionally, certain bonds are so widely sought after that you can actually repo them at a *negative* interest rate. In other words, people will pay to lend you money if you pony up certain bonds as security.

This is known as the bond trading "on special", or "specialness", and usually happens because they are the cheapest securities to deliver to meet a derivatives contracts. Here's ICMA's explainer of the concept:

> A *special* is an issue of securities that is subject to exceptional demand in the repo and cash markets compared with very similar issues. Competition to buy or borrow a special causes potential buyers in the repo market to offer cheap cash in exchange. A special is therefore identified by a repo rate that is distinctly lower than the GC repo rate. The demand for some specials can become so strong that the repo rate on that particular issue falls to zero or even goes negative in an otherwise positive interest rate environment. The repo market is the only financial market in which, historically, a negative rate of return has not been unusual.

Perhaps more bonds are on special these days, because of the growth of Treasury futures used for basis trades, and that is also affecting the haircuts as well as rates? But we're now just spitballing.

Anyway, there are lots of other fascinating titbits in the ECB report, such as hedge funds being net lenders in the euro repo market but net borrowers in dollars; the swelling involvement of other non-bank financial institutions; the growing prevalence of longer-term repo; and just how enmeshed European banks are across the board. But the frequency of negative haircuts jumped out to Alphaville.

Does this matter? Well, yes. It is said that armchair soldiers study tactics, while generals study logistics. In finance, more people should probably study repo. It is like the global bond market's hidden circulatory system, and we should be more alert to developments there.

That negative haircuts are not quite as rare as thought implies that 1) investment banking divisions remain heavily enmeshed with their commercial banking divisions despite efforts to ringfence operations a little since 2008, and 2) that leverage is probably a bit too freely available in repo markets, and even small shifts in haircut standards could now have dangerous consequences.

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