Demystifying Repo Haircuts

ICMA
International Capital Market Association

September 2025

"Haircuts" applied to repo transactions, and securities financing transactions (SFTs) more broadly, periodically come under the regulatory spotlight, particularly in the context of discussions around excessive leverage and potential risks for financial stability. The application of haircuts has recently garnered fresh attention as part of the broader focus on non-bank financial intermediation and related risks (see FSB: Leverage in Nonbank Financial Intermediation), with some questioning prevailing haircut practices, not least the observation of zero and so-called "negative haircuts" (see ECB: The international dimension of repo: five new facts).

This short paper intends to help inform the related policy debate by seeking to demystify repo haircuts and addressing some misconceptions.

The purpose of haircuts[1]

A repo haircut is a reduction (or in some cases an increase) in the market value of the collateral underpinning the repo. It is the difference between the initial market value of an asset and the purchase price paid for that asset at the start of a repo, expressed as a percentage difference to the market value of the collateral. Haircuts result in one of the parties effectively being over-collateralised, and, by implication, the other party being under-collateralised. In many respects it serves the same purpose as initial margin (IM) posted in CCP-cleared transactions.

Given the one-way nature of haircuts, both parties could reasonably demand a haircut to protect against counterparty default, with the lender of the cash worried about changes in the market value of the collateral, and the lender of securities concerned about possible replacement risk.

If one considers a repo as a tool for lending cash on a secured basis (noting that this is just one function of the repo market), the lender of cash has the security of collateral in the event of default, which serves as a counterparty credit risk mitigant. However, this assumes that the cash lender is able to sell the securities at a predictable price, as reflected in the variation margin valuation at the time of default. In reality, this is unlikely, even in the case of the most liquid collateral (eg government bonds), and so the cash lender may need to consider a range of factors that could result in them receiving less than the value of the loan in the case of liquidation. These include:

- Price volatility following the last variation margin payment
- The potential impact of liquidation on the market price of the securities (also taking into account concentration risk)
- The possibility of the issuer of the collateral defaulting
- Delays in variation margin being paid (due to operational or legal issues, or even holidays)
- Exchange rate volatility in the case of cross-currency repo

A consideration of these factors, along with data-driven probability analyses, could justify the lender of the cash applying a haircut to the lender of the collateral. The term of the repo also needs to be factored into this, given that it may not be possible to adjust the haircut over the life of the transaction. However, it is important to note that all of these factors are related to liquidation risk, not counterparty credit risk. In other words, the haircut is a function of the underlying collateral, and not the probability of default of the counterparty lending the collateral.[2]

That said, in reality market participants do also price the probability of counterparty default into haircuts, requiring higher haircuts in the case of counterparties with lower credit quality. This is particularly pertinent in the case where the underlying collateral is of relatively low quality, or where the probability of collateral and counterparty default are highly correlated (so called "wrong-way risk"). There are additional advantages of demanding higher haircuts (discussed further on), and where the relative bargaining power of the counterparties can also play a role.

1 An initial margin in the repo market is the ratio of the initial market value of an asset and the purchase price paid for that asset at the start of a repo expressed as a percentage of the market value of the collateral. In other word, it is a different way of expressing the same difference. Initial margin in the repo market should be distinguished from the initial margins applied by a CCP, which are upfront deposits made by both counterparties to the CCP, although they perform a similar function. See ICMA website: Frequently Asked Questions on Repo> 21.What is a haircut?

2 In theory any counterparty credit risk should be priced into the repo rate, not the haircut.

Applying this principle, it is therefore not unusual for counterparties, including dealers, to pay haircuts in financing trades where they are the borrower of cash. One notable exception is the interdealer market where haircuts are generally not applied and, in particular, the automatic electronic interdealer market, where haircuts would obstruct matching on central limit order books (CLOB). However, where the underlying collateral being financed is of sufficiently low quality, or is relatively illiquid, or the repo is for a longer term, haircuts could be required even between dealers.

Additionally, dealers may also pay haircuts to dealer counterparts where they are utilising their counterparty's sponsored repo clearing services (in cases where one party is a direct participant of a CCP, but not both). At a minimum this would cover the sponsoring member's initial margin requirements with the CCP.

Negative haircuts

Given the rationale for applying haircuts to the borrower of cash to mitigate the liquidation risk associated with the repo collateral, it may at first seem curious to find common instances where it is the lender of the cash who pays the haircut (effectively a "negative haircut"). However, this is quite normal in the case of "specific collateral" (or SC) transactions as distinct from "general collateral" (GC) transactions. In the case of the latter, the motivation for the trade is to borrow cash for funding purposes, where the lender of the cash may reasonably seek a haircut to mitigate any possible liquidation risk. In the case of the former, the lender of the cash is borrowing a specific security for an explicit purpose, such as covering an existing or anticipated short sale, hedging short positions in deliverable futures contracts, or resolving a settlement fail.

Banks are frequent borrowers of SC both to support their own trading and market-making activity as well as for clients, across a whole range of asset classes and collateral types. Indeed, SC has dominated the repo market since the Global Financial Crisis.

It should also be noted that SC repo rates frequently trade below GC repo rates,[3] with the difference (the "specialness") being driven by the borrowing demand and lending supply in the specific security.[4] Much of the lending supply for SC comes from agent lenders (usually custodian banks) who lend securities on behalf of their clients in order to earn additional revenues from their holdings so boosting returns. However, as part of the lending agreement, agents commit to return any securities that are loaned on behalf of the beneficial owner. This creates a risk in the event that the borrower of the securities is unable to return them. Should the borrower of the securities be unable to return these, perhaps because it has defaulted, the agent lender would have to source the securities in the cash market, exposing them not only to the bid-ask spread, but also to market risk in terms of price volatility as well as liquidity risk. To mitigate this exposure, it is customary for the borrower of the securities to pay a haircut to the lender, thereby providing more cash than the market value of the collateral. This rationale and requirement for overcollateralising a loan of SC is also commonly applied by direct real money lenders, such as asset managers, pension funds, insurers, and sovereign wealth funds (although less common in the case of leveraged lenders where any haircut is likely to be applied by the dealer).

To put it more succinctly, in the case of a security-driven trade as opposed to a cash-driven trade, the justification (and requirement) for a haircut switches from the lender of the cash to the lender of the securities.

A further observation noted in some recent studies and analyses[5] is the instance of zero haircuts in the case of inter-affiliate transactions. Given that risk is likely to be consolidated at the group level, it could be reasonably argued that applying haircuts is an unnecessary and cumbersome requirement. Furthermore, imposing a haircut could complicate balance sheet management, creating intra-group mismatches with respect to cash and collateral flows.

3 In the case of securities lending transactions, borrowers of securities pay a fee to the lender, usually expressed in terms of annualised basis-points charged on the market value of the securities. This is the equivalent of the repo market GC-SC spread.

4 When looking at EU SFTR data, it is important to look at the actual repo rates or securities lending fees to distinguish between GC and genuine SC. This is because, outside of triparty, it is quite normal to allocate specific collateral (ie individual ISINs) against GC trades. While all repos against multiple securities are GC, not all GC repos are against multiple securities.

5 Hermes et al, The International Dimension of Repo: Five New Facts, ECB WP3065, July 2025. Friedrichs et al, Affiliate Repo and the 2024 STFM Update, OFR Blog 07 August 2025.

Haircuts vs aggregate margining

In their intermediation capacity, banks will, as a matter of course, enter into a large number of repo transactions with their (non-bank) clients, which could include both the lending and borrowing of collateral, often with similar (same issuer) or highly correlated underlying securities. In this instance, applying haircuts at the individual trade level can become inefficient, suggesting that margining at the net exposure level would be more effective from a risk management perspective. In reality, this reflects the risk exposure in the event of default where close-out netting is applied.

Similarly, this portfolio approach to margining could extend to other transactions and exposures, including prime brokerage margin lending and OTC derivatives. In many ways it makes more sense to calculate and margin holistically at the counterparty level, rather than at the individual transaction level, particularly where set-off netting agreements between different products and their related contractual frameworks are in place.

With this in mind, it becomes difficult, if not impossible, to draw meaningful conclusions from transaction-level data on haircuts. Only by looking at a bank's net exposure to a counterparty, and the associated liquidation risk, can it be determined whether the bank has sufficient margin to mitigate this.

A good example of portfolio level margining is in the case of banks' hedge fund clients, where activity may involve both lending and borrowing securities, OTC derivatives, as well as prime brokerage services. In such cases, where banks have an enforceable right to net across products, banks may offer cross-product margining in order to determine an amount of margin that reflects the true aggregate risk the bank might face in a close-out scenario.

Incentives for haircuts

It is a simple fact that haircuts, by their very nature, are asymmetrical and therefore a cost to doing SFT business for one of the counterparties. In the case of cash-driven transactions, the borrower of the cash may be required to make up for the short-fall in the repo value (ie the haircut amount) via other, more expensive funding channels, such as the unsecured market. Similarly, in the case of security-driven transactions, the borrower of the securities faces the opportunity cost of putting up more cash (or non-cash collateral in the case of securities lending) than the value of the securities being borrowed (the negative haircut).

In the case of bank entities, the cost of paying away haircuts is compounded by the capital costs associated with haircuts. In the scenario of reverse repos (ie banks borrowing collateral), the haircut paid to unrated non-banks (such as asset managers or pension funds) is subject to a Risk Weighted Asset (RWA) computation, which can be high. In the EU, for example, CRR3 sets this RWA weighting at 100% under the Standardised Approach. In other words, the full value of the haircut sits on the bank's balance sheet as a drain on capital.

Receiving haircuts from counterparties in order to offset haircuts being paid is therefore a strong commercial incentive for banks, beyond managing the liquidation risk of their repo exposures. While discourse on SFT haircuts suggests that banks are often under pressure from clients to reduce haircuts in order to win business (noting that the cost of a haircut to the payer can be a far more material consideration than the repo rate), banks equally have a powerful rationale for increasing haircuts where they can; if not at the individual transaction level, then certainly at the portfolio level.

Implications for policy makers

Drafting regulation to address perceived risks to financial stability stemming from haircuts, in particular the role of haircuts in constraining leverage, is nothing new. In November 2012, the FSB floated the idea of mandatory minimum haircuts. In July 2021 the BCBS published its recommendations for setting minimum haircut floors for securities financing transactions. The latter framework sets out minimum haircuts to be paid by non-prudentially regulated entities in the case of them borrowing cash against non-government securities, including non-cash collateral upgrades.[6] It further provides a formula for the netting of haircuts on a repo portfolio basis.

However, to date no major jurisdiction, to ICMA's knowledge, has attempted to implement the Basel recommendations, recognising the inherent limitations: namely the impact on security-driven lending (where negative haircuts are justified); the inappropriateness of

6 This is where a bank lends lower quality collateral to a counterparty against receiving higher quality (usually HQLA) collateral in return for a fee (or spread).

a one-size fits all haircut calibration; and the argument for margining counterparties holistically.

When thinking about policy interventions with respect to haircuts, perhaps the starting point should be to ask the question: *what are we trying to solve?*

If the aim is to constrain leverage, is regulating haircuts on individual transactions the most effective and direct policy tool? It is true that in the case of financing trades repo can provide leverage, and that haircuts, or any form of initial margin, naturally reduce the quantum of leverage. However, different entities have very different leverage profiles, the appropriateness of which can vary over time, and that can only be measured meaningfully at a holistic entity level. Furthermore, haircuts are not intended to curb leverage: they are primarily a management tool for liquidation risk.

It has also been touted that applying minimum haircuts in the non-centrally cleared market would create a level playing field for CCPs in the bid to attract more repo into clearing. But comparing bilateral transactions with central clearing is a misleading parallel, with a different set of risk management considerations and objectives. If anything, a better solution would be to work on removing any unnecessary barriers to central clearing, such as capital costs for sponsors, counterparty concentration limits with CCPs, collateral eligibility, or limitations on collateral re-use by certain entities.

Since haircuts are effectively an opaque additional transaction level cost for one of the counterparties, they potentially have a distortive effect on pricing and activity, which has implications for market efficiency. This needs to considered in light of the many uses of repo, which is far broader than leveraged finance, and includes funding market making and liquidity provision in the underlying market, as well as central bank monetary policy transmission. A further unintended outcome could be to incentive market participants to transition from using repo to economically equivalent products such as securities lending or total return swaps (TRS).

Just as haircut data do not tell us very much about systemic leverage or potential risks to financial stability, the conclusion may be that nor are haircuts an effective policy tool for managing such risks.

About the ERCC

The ICMA European Repo and Collateral Council (ERCC) was established in 1999 as the main representative body for the cross-border repo and collateral market in Europe. The ERCC aims to develop consensus solutions for issues arising in a rapidly evolving marketplace and consolidates and codifies best market practice. Membership of the ERCC is open to ICMA members who are active in repo and associated collateral business in Europe. The ICMA ERCC currently has around 120 members, comprising the majority of firms actively involved in this market.

In September 2022, in recognition of the increasingly global nature of much of ICMA's repo and collateral work, ICMA established the Global Repo and Collateral Forum (GRCF). The GRCF is open to ICMA members around the world with an interest in repo and collateral and will complement the existing governance framework centred around the ERCC.

For further details on the ERCC and to get involved please contact ercc@icmagroup.org. If you would like to sign up to the GRCF or have any related questions please send an email to grcf@icmagroup.org.

About the GMRA

Since the early 1990's, ICMA has played a significant role in promoting the interests and activities of the international repo market, and of the product itself. This includes the development of the Global Master Repurchase Agreement (GMRA), which has become the principal master agreement for cross-border repos globally, as well as for many domestic repo markets.

Authors:

Andy Hill, ICMA
andy.hill@icmagroup.org

Alexander Westphal, ICMA
alexander.westphal@icmagroup.org