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Senior Credit Officer Opinion Survey on Dealer Financing Terms

September 2015

The September 2015 Senior Credit Officer Opinion Survey on Dealer Financing Terms

Summary

The September 2015 Senior Credit Officer Opinion Survey on Dealer Financing Terms collected qualitative information on changes over the previous three months in credit terms and conditions in securities financing and over-the-counter (OTC) derivatives markets. In addition to the core set of questions, the survey included a set of special questions on the effects of derivatives central-clearing mandates on clients' use of central counterparty clearing services since the beginning of 2014. The 20 institutions participating in the survey account for almost all dealer financing of dollar-denominated securities to nondealers and are the most active intermediaries in OTC derivatives markets. The survey was conducted during the period between August 18, 2015, and August 31, 2015. The core questions asked about changes between June 2015 and August 2015.[1]

Responses to the core questions in the September survey offered a few insights regarding recent developments in dealer-intermediated markets:

- Similar to the June survey, nearly one-third of respondents reported an increase in resources and attention devoted to the management of concentrated credit exposure to central counterparties and other financial utilities over the past three months.

- Dealers indicated that, on net, the use of financial leverage by all classes of counterparties included in the survey had remained basically unchanged over the past three months.

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[1] For questions that ask about credit terms, reported net percentages equal the percentage of institutions that reported tightening terms ("tightened considerably" or "tightened somewhat") minus the percentage of institutions that reported easing terms ("eased considerably" or "eased somewhat"). For questions that ask about demand, reported net fractions equal the percentage of institutions that reported increased demand ("increased considerably" or "increased somewhat") minus the percentage of institutions that reported decreased demand ("decreased considerably" or "decreased somewhat").

- Continuing a trend seen in recent surveys, a net fraction of one-third of dealers noted an increase in funding demand for non-agency residential mortgage-backed securities (RMBS).

- Over one-third of respondents indicated that effective financing rates (collateral spreads over the relevant benchmark) in securities financing transactions have increased for high-yield corporate bonds, non-agency RMBS, and commercial mortgage-backed securities (CMBS) over the past three months. In addition, on net, approximately one-third of respondents indicated that the liquidity and functioning of the markets for high-yield corporate bonds, CMBS, and consumer asset-backed securities (ABS) have deteriorated.[2]

- In responses to the set of special questions regarding clients' use of central counterparty clearing services for OTC derivatives, nearly one-half of dealers reported an increase in the use of credit and interest rate derivative contracts that are subject to mandatory clearing since the beginning of 2014. Over three-fourths of respondents who reported an increase cited clients' need to comply with mandatory clearing requirements as among the most important reasons for the increase. Over four-fifths of respondents noted that the use of clearing services for derivatives eligible but not mandated for clearing remained largely unchanged over the same period. The most important reasons for the increase in clearing services for credit derivatives eligible for clearing (but not mandated) were expansion in the scope of clearing-eligible products and margin efficiency or other cost savings for cleared transactions. Regarding how different client types have altered their use of clearing services, on net, about two-fifths of respondents indicated that dealers, other financial intermediaries, hedge funds, and separately managed accounts increased their use of clearing services. Approximately one-fourth of the respondents indicated that mutual funds, exchange-traded funds (ETFs), pension plans, and endowments increased their use of clearing services.

Counterparty Types

(Questions 1–40)

Dealers and Other Financial Intermediaries. As in the past several surveys, over four-fifths of respondents to the September survey reported that the amount of resources and attention devoted to the management of concentrated credit exposure to dealers and other financial intermediaries remained basically unchanged over the past three months, while

[2] Note that survey respondents were instructed to report changes in liquidity and functioning in the market for the underlying collateral to be funded through repurchase agreements and similar secured financing transactions, not changes in the funding market itself. This question was not asked with respect to equity markets in the core questions.

the remainder pointed to an increase (see the exhibit "Management of Concentrated Credit Exposures and Indicators of Supply of Credit.")

Central Counterparties and Other Financial Utilities. In the September survey, nearly one-third of respondents indicated that they had increased the amount of resources and attention devoted to the management of concentrated credit exposures to central counterparties and other financial utilities over the past three months. One-fourth of dealers noted that changes in the practices of central counterparties, including changes in margin requirements and haircuts, had influenced, to some extent, the credit terms applied to clients on bilateral transactions that are not cleared.

Hedge Funds. Most respondents to the September survey indicated that both price terms (such as financing rates) and nonprice terms (including haircuts, maximum maturity, covenants, cure periods, cross-default provisions, and other documentation features) offered to hedge funds for securities financing and OTC derivatives transactions were little changed over the past three months. Over four-fifths of dealers reported no change in differential terms to their most-favored hedge funds, with the remaining indicating that differential terms had increased somewhat. The intensity of efforts by hedge fund clients to negotiate more-favorable terms remained essentially unchanged. On net, the use of leverage and the availability of additional (and not utilized) financial leverage under agreements currently in place with hedge funds also remained unchanged over the past three months (see the exhibit "Use of Financial Leverage.")

Trading Real Estate Investment Trusts. One-fourth of respondents to the September survey indicated that while price terms offered to trading real estate investment trusts had tightened somewhat over the past three months, nonprice terms had remained about unchanged on net. The provision of differential terms to most-favored clients and the intensity of efforts by clients to negotiate more-favorable terms were also reported to be little changed, as was the use of financial leverage.

Mutual Funds, Exchange-Traded Funds, Pension Plans, and Endowments. As in previous surveys, almost all respondents to the September survey indicated that both price and nonprice terms offered to mutual funds, ETFs, pension plans, and endowments had remained basically unchanged over the past three months. Provision of differential terms to most-favored clients and the intensity of efforts by clients to negotiate more-favorable terms were reported to be little changed overall. Almost all respondents indicated that the use of financial leverage had remained unchanged over the past three months.

Insurance Companies. Respondents to the September survey indicated that both price and nonprice terms offered to insurance companies had changed little over the past three months, as had the use of financial leverage. Provision of differential terms to most-favored clients were also reported to be little changed. On aggregate, the intensity of efforts by clients to negotiate more-favorable terms was little changed.

Separately Managed Accounts Established with Investment Advisers. All of the dealers indicated in the September survey that price and nonprice terms negotiated by investment advisers on behalf of separately managed accounts were basically unchanged over the past three months. Provision of differential terms to most-favored clients and the use of financial leverage by investment advisers were also reported to be unchanged, as was the intensity of efforts by investment advisers to negotiate more-favorable terms.

Nonfinancial Corporations. Respondents indicated that both price and nonprice terms offered to nonfinancial corporations had remained largely unchanged over the past three months. The intensity of efforts by nonfinancial corporations to negotiate more-favorable price and nonprice terms remained unchanged.

Mark and Collateral Disputes. As in previous surveys, respondents in September indicated that the volume, persistence, and duration of mark and collateral disputes with all counterparty types included in the survey were little changed over the past three months.

Over-the-Counter Derivatives

(Questions 41–51)

In the September survey, all firms reported that nonprice terms (such as acceptable collateral, covenants, and the recognition of portfolio or diversification benefits) incorporated in new or renegotiated OTC derivatives master agreements were basically unchanged over the past three months.[3] For all contract types surveyed, initial margins for average and most-favored clients were also reportedly little changed.[4]

Dealers reported little change in the use of nonstandard collateral—that is, collateral other than cash and U.S. Treasury securities—to fulfill margin requirements. On net, respondents generally reported that the volume, persistence, and duration of mark and collateral disputes had remained unchanged for all contract types.

[3] The survey asked specifically about requirements, timelines, and thresholds for posting additional margin, acceptable collateral, recognition of portfolio or diversification benefits, triggers and covenants, and other documentation features, including cure periods and cross-default provisions.

[4] Contract types included in the survey are OTC foreign exchange derivatives, interest rate derivatives, equity derivatives, credit derivatives, securitized product derivatives, commodity derivatives, and total return swap referencing nonsecurities (such as bank loans).

Securities Financing

(Questions 52–79)[5]

Effective financing rates (collateral spreads over the relevant benchmark) in securities financing transactions were reported to have been increased for riskier collateral types covered by the survey over the past three months. Specifically, approximately two-fifths of respondents reported an increase in financing rates for high-yield corporate bonds and non-agency RMBS, while almost one-third of respondents reported an increase in financing rates for CMBS. Smaller fractions of respondents reported increases in the financing rates for high-grade corporate bonds, equities, agency RMBS, and consumer ABS. Haircuts on securities financing transactions, however, were reported to be little changed on net.

As in previous surveys, two-fifths of dealers pointed to an increase in demand for funding of non-agency RMBS over the past three months (see the exhibit “Measures of Demand for Funding and Market Functioning.”) Almost one-half of respondents reported an increase in demand for term funding—that is, funding with a maturity greater than 30 days—of non-agency RMBS. For other collateral types covered by the survey, respondents indicated that demand for funding and term funding has remained basically unchanged on net.

Significant net fractions of respondents indicated that the liquidity and functioning of the markets for most of the underlying collateral types covered by the survey has deteriorated over the past three months. Notably, about one-fifth of respondents reported that liquidity and underlying functioning has deteriorated in the high-grade corporate bond market, and more than one-third reported deterioration in the high-yield bond market. In addition, a net fraction of almost one-third of respondents reported a deterioration in the liquidity and functioning of CMBS and consumer ABS markets.

Despite reported increases in financing rates and a deterioration in market liquidity and functioning in a number of markets, similar to previous surveys, all respondents indicated that the volume, duration, and persistence of mark and collateral disputes were basically unchanged for all of the collateral types.

Special Questions on Clients’ Use of Central Clearing Counterparty Services for Over-the-Counter Derivatives Contracts

(Questions 81–90)

In 2009, the G-20 leaders agreed that all standardized OTC derivatives contracts should be cleared through central counterparties. In the United States, mandatory clearing requirements for certain standardized interest rate swaps (IRS) and credit default swap

[5] Question 80, not discussed here, was optional and allowed respondents to provide additional comments.

(CDS) index products were phased in over the course of 2013 by the Commodities Futures Trading Commission under new authority provided by the Dodd-Frank Act. In addition to those products whose clearing is mandatory, many CDS and IRS products are eligible for clearing but are not required to be cleared. The September survey's set of special questions asked participants how and why their clients' use of OTC credit and interest rate derivatives subject to mandatory clearing has changed since January 1, 2014. It also asked how and why the use of clearing services has changed for OTC credit and interest rate derivatives that are eligible for clearing but for which clearing is not mandated.

Regarding the use of credit and interest rate derivatives subject to mandatory clearing, one-third of the dealers reported little change in clients' use of U.S. dollar (USD)-denominated OTC credit derivatives, and one-half of the dealers reported little change in clients' use of USD-denominated OTC interest rate derivatives. Almost one-half of respondents indicated an increase in clients' use of credit derivatives, and two-fifths indicated an increase in clients' use of interest rate derivatives.

Respondents reporting a change in client use of derivatives subject to mandatory clearing requirements were asked to identify up to two of the most important reasons for the change. Three-fourths of the dealers reporting an increase in the use of credit derivatives subject to mandatory clearing pointed to the need to comply with mandatory clearing requirements as among the reasons for the increase, while about one-third identified counterparty risk mitigation associated with central clearing as among the reasons for the increase.[6] Similarly, among the dealers noting an increase in the use of interest rate derivatives subject to mandatory clearing, all pointed to the need to comply with mandatory clearing requirements. Among dealers reporting a decrease in client use of OTC derivatives subject to mandatory clearing requirements, higher margins or other costs associated with cleared transactions was the most frequently cited reason.

Regarding OTC derivatives not subject to mandatory clearing but eligible to be cleared, approximately two-thirds of respondents reported no change in the use of central clearing services. However, one-fifth of dealers reported an increase in the use of clearing services for credit derivatives and almost one-third reported an increase for interest rate derivatives. The most important reasons for the increase in clearing services for credit

[6] Dealers could attribute an increase in use to the need to comply with mandatory clearing, other differential regulatory treatment of cleared and noncleared transactions (such as differences in capital requirements or exchange/platform trading requirements), counterparty risk mitigation associated with clearing, or margin efficiency or other costs savings for cleared transactions. When reporting a decrease, dealers could attribute it to lack of access to clearing services, differential regulatory treatment of cleared and noncleared transactions (such as differences in capital requirements or exchange/platform trading requirements), the desire to manage risk exposure to central counterparties, or higher margin requirements or other transaction costs. Respondents could choose up to two reasons for the increase or decrease in usage.

derivatives eligible (but not mandated) for clearing were expansion in the scope of clearing-eligible products and margin efficiency or other cost savings for cleared transactions.[7] With respect to interest rate derivatives, the most important reasons for the increase were expansion in the scope of clearing-eligible products, counterparty risk mitigation associated with clearing, and margin efficiency or other costs savings for cleared transactions. Of note, one-tenth of respondents reported a decrease in the use of clearing services for both credit and interest rate derivatives eligible for clearing but not mandated for clearing. The two main reasons cited for the decrease were higher margin requirements or other costs for cleared transactions, and differential regulatory treatment for cleared and noncleared transactions (such as differences in capital requirements or exchange/platform trading requirements).

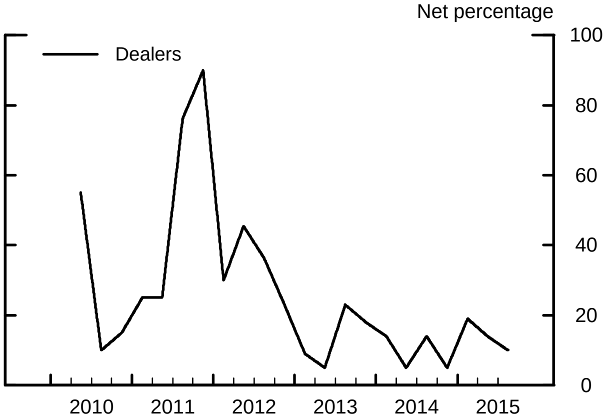
The September survey also asked how the use of central clearing services for OTC derivatives (whether subject to mandatory clearing or not) has changed for different client types. On net, two-fifths of respondents indicated that dealers and other financial intermediaries have increased their use of clearing services for both credit and interest rate OTC derivatives. Responses were similar for hedge funds and separately managed accounts, where two-fifths of dealers reported an increase in client use of clearing services for credit OTC derivatives and one-third reported an increase in client use of clearing services for interest rate OTC derivatives. One-fourth of respondents reported that mutual funds, ETFs, pension plans, and endowments also increased their use of clearing services for both credit and interest rate OTC derivatives.

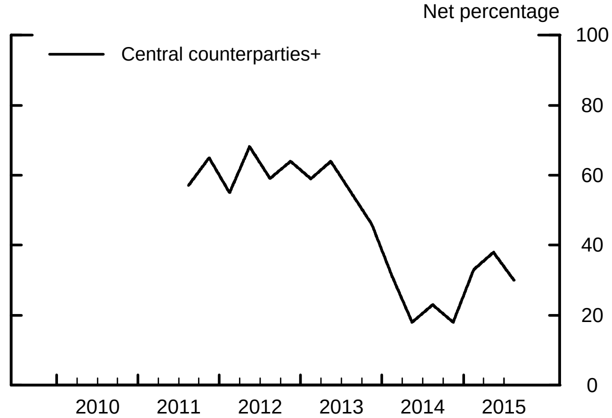
This document was prepared by Sebastian Infante, Division of Monetary Affairs, Board of Governors of the Federal Reserve System. Assistance in developing and administering the survey was provided by staff members in the Statistics Function and the Markets Group at the Federal Reserve Bank of New York.

[7] Dealers could attribute an increase in use to expansion in scope of clearing-eligible products, differential regulatory treatment of cleared and noncleared transactions (such as differences in capital requirements or exchange/platform trading requirements), counterparty risk mitigation associated with clearing, or margin efficiency or other costs savings for cleared transactions. When reporting a decrease, dealers could attribute it to lack of access to clearing services, differential regulatory treatment of cleared and noncleared transactions (such as differences in capital requirements or exchange/platform trading requirements), the desire to manage risk exposure to central counterparties, or higher margin requirements or other transaction costs. Respondents could choose up to two reasons for the increase or decrease in usage.

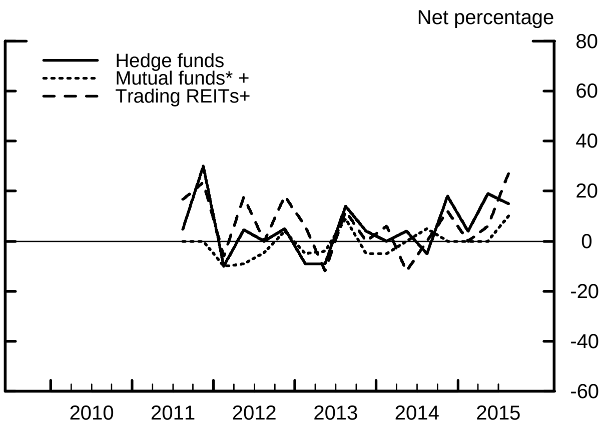
Management of Concentrated Credit Exposures and Indicators of Supply of Credit

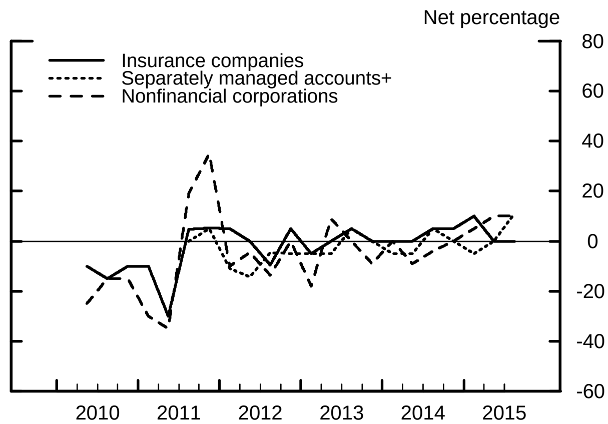
Respondents increasing resources and attention to management of concentrated exposures to:



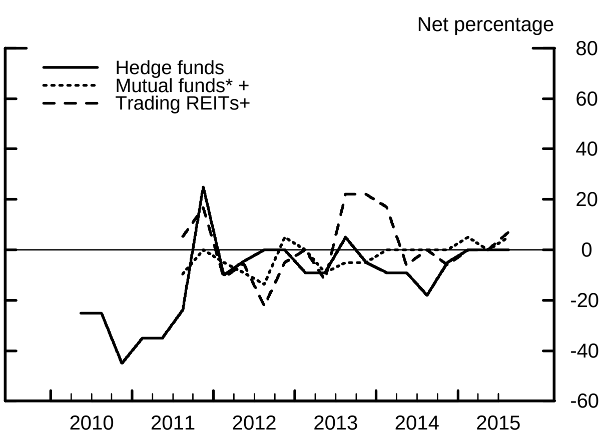


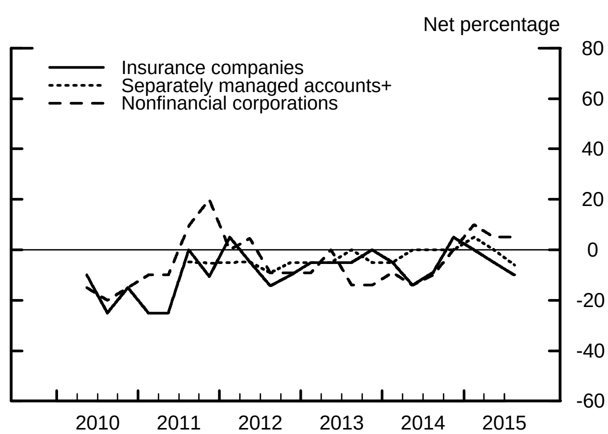
Respondents tightening price terms to:





Respondents tightening nonprice terms to:

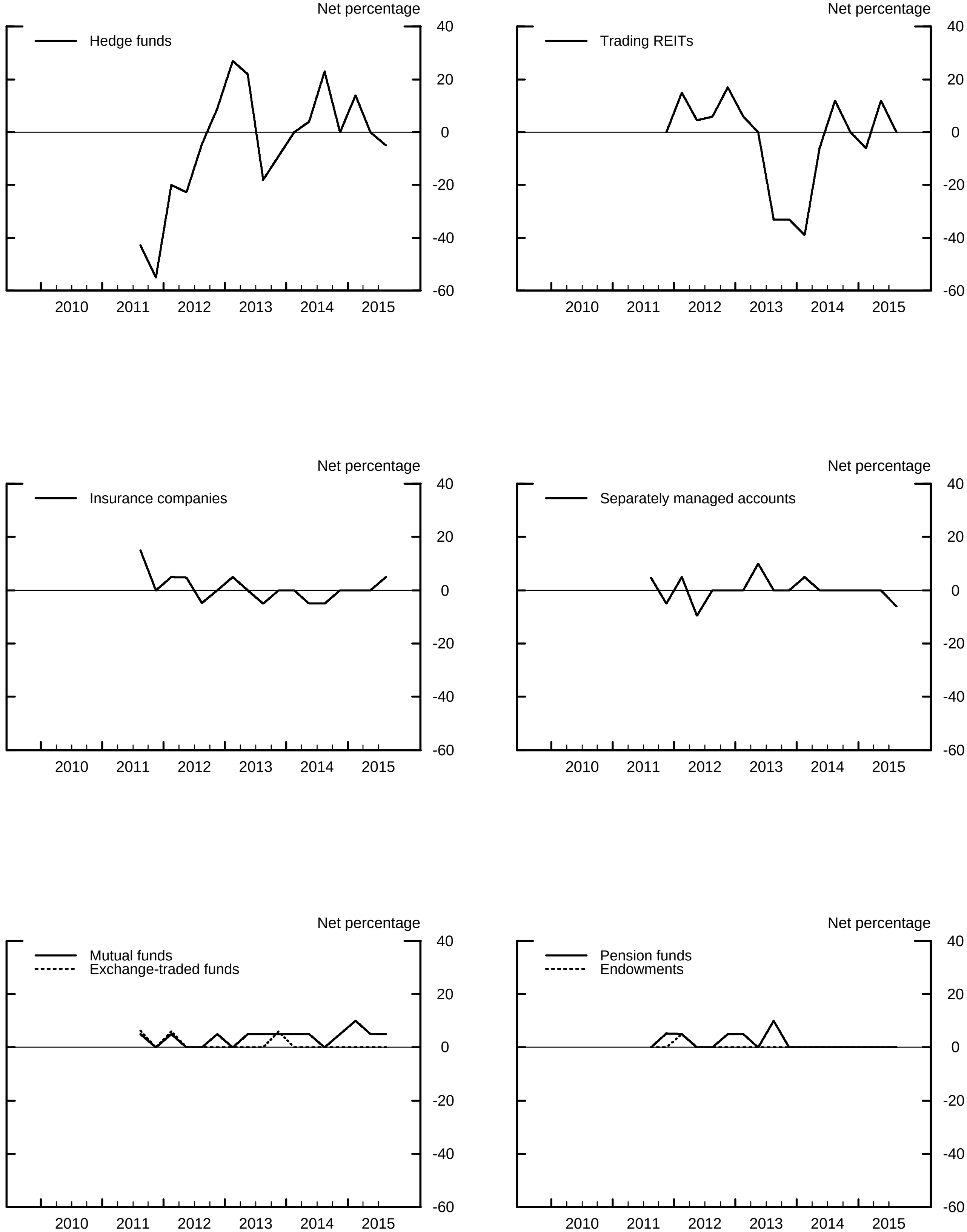




+ This question was added in the September 2011 survey.
* Includes mutual funds, exchange-traded funds, pension plans, and endowments.

Use of Financial Leverage

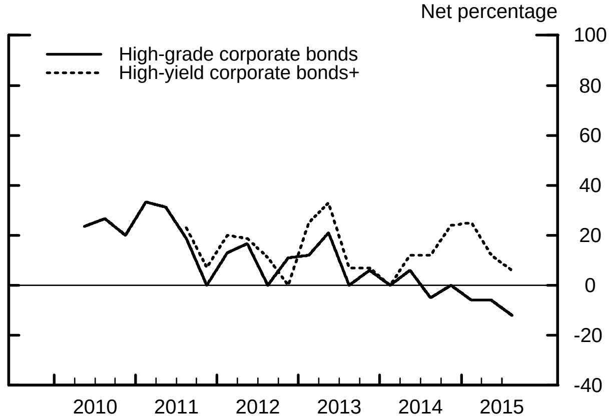
Respondents reporting increased use of leverage by:

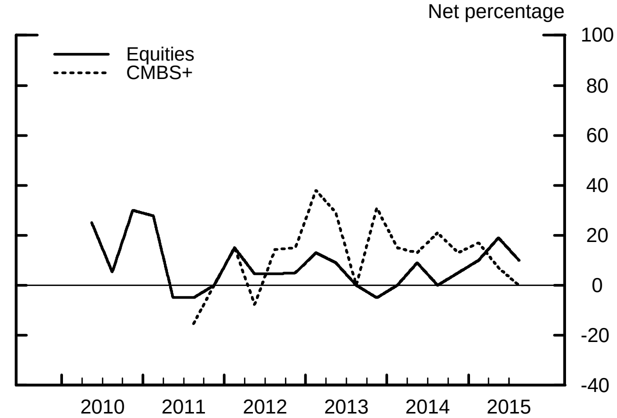


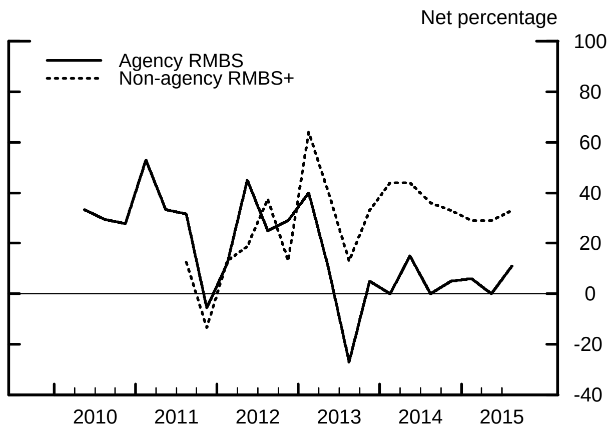
Note: All questions regarding counterparties use of financial leverage were added in the September 2011 survey.

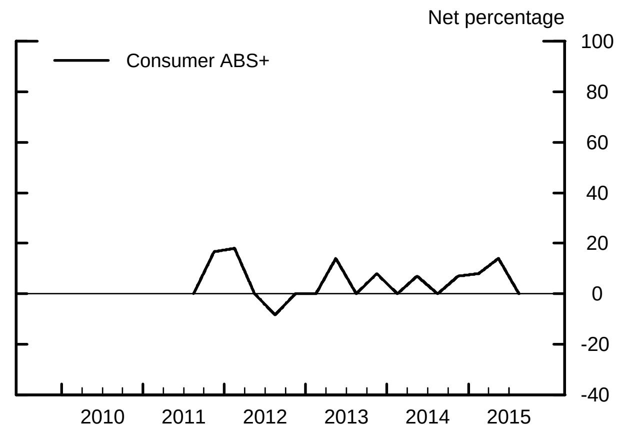
Measures of Demand for Funding and Market Functioning

Respondents reporting increased demand for funding of:

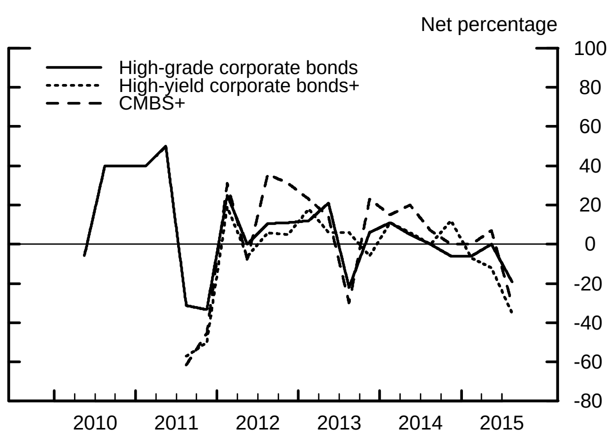


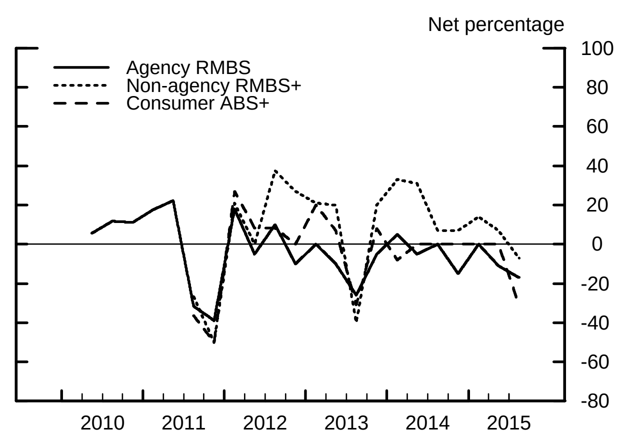






Respondents reporting an improvement in liquidity and functioning in the underlying markets for:





+ This question was added in the September 2011 survey.