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Senior Credit Officer Opinion Survey on Dealer Financing Terms

June 2016

The June 2016 Senior Credit Officer Opinion Survey on Dealer Financing Terms

The June 2016 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 questions, the survey included a set of special questions about the use of synthetic prime brokerage (PB) by hedge fund clients to provide levered exposure to assets. 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 May 17, 2016, and May 31, 2016. The core questions asked about changes between March 2016 and May 2016.[1]

Core Questions
(Questions 1–79)[2]

Survey respondents generally reported little change in conditions over the past three months in pricing and across markets and instruments covered in the core questions of the survey. The responses, however, offered a few insights regarding recent developments in dealer-intermediated markets:

- One-fifth of respondents reported an increase in resources and attention devoted to the management of concentrated credit exposure to central counterparties and other financial utilities.
- Price and nonprice terms on securities financing transactions and OTC derivatives were basically unchanged across all classes of counterparties over the past three months. A small fraction of respondents reported that efforts by hedge funds to negotiate more-favorable terms had increased somewhat over the same period.
- On net, a small fraction of dealers indicated that the use of financial leverage by hedge funds had decreased somewhat over the past three months. For all other classes of counterparties, use of financial leverage was little changed. In addition, the majority of respondents noted that the volume, duration, and persistence of mark and collateral disputes with all counterparty types were basically unchanged.
- Dealers reported that initial margin requirements on OTC derivatives were basically unchanged for average and most-favored clients. A small fraction of

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[1] For questions that ask about credit terms, 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, 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").

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

respondents reported that initial margin requirements on foreign exchange derivatives had increased somewhat for average clients. The volume and duration and persistence of mark and collateral disputes on OTC derivatives was also basically unchanged over the past three months. However, a small fraction of dealers indicated that the volume of disputes on OTC interest rate derivatives had decreased somewhat.

- With respect to securities financing transactions, small fractions of dealers noted an increase over the past three months in financing rates (collateral spreads over the relevant benchmark) for average clients on equities and on non-agency residential mortgage-backed securities (RMBS).
- Small net fractions of dealers reported an increase in demand for funding for non-agency RMBS as well as an increase in demand for term funding of agency RMBS over the past three months. Survey respondents indicated that liquidity and market functioning across all asset classes was basically unchanged.

Special Questions on Synthetic Prime Brokerage
(Questions 81–87)

In the March 2014 survey, respondents were queried about the use of synthetic prime brokerage (PB) by hedge fund clients. Under such arrangements, levered exposure is created through total return swaps and other OTC derivatives rather than through traditional secured financing such as margin lending or repurchase agreements. In the current survey, we revisited questions about the use of synthetic PB arrangements and also asked additional questions related to the hedging of client swaps and counterparty risk-management practices.

With respect to the use of synthetic PB by clients, responses to the special questions revealed the following:

- Survey respondents indicated that the use of synthetic PB varied widely across different types of hedge fund clients.[3] Dealers were most likely to cite equity long-short hedge funds that are fundamentally oriented as significant users, with one-third of dealers indicating that synthetic PB was widely employed by a large number of clients and an additional three-fifths of respondents pointing to use by some clients or in some situations. Fractions of dealers ranging between three-fifths and four-fifths reported that synthetic PB was employed significantly by the other three categories of equity funds covered in the survey.[4] With the exception of credit-oriented funds, at least one-half of respondents reported significant use of synthetic PB for each hedge fund category included in the question. The relative ranking of hedge fund categories by reported use of synthetic PB was very similar to the ranking in the March 2014 survey.

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[3] As in March 2014, the survey asked about hedge fund clients in seven categories: equity long-short hedge funds (fundamentally oriented), equity long-short hedge funds (quantitatively oriented), event-driven equity funds, other equity funds, macro-oriented hedge funds, credit-oriented hedge funds, and emerging market–oriented hedge funds.

[4] In this report, the term “significant use” indicates a response that synthetic PB is widely used by a large number of clients or a response that synthetic PB is employed by some clients or in some situations.

- More than two-fifths of respondents reported that the use of synthetic PB by equity long-short hedge funds (both fundamentally oriented and quantitatively oriented) had increased since March 2014. For other categories of hedge funds, dealers on balance pointed to little change in the use of synthetic PB since March 2014.
- Respondents were also asked about several possible motivations for hedge funds' use of synthetic PB.[5] Four-fifths of respondents indicated that access to foreign markets was very important, making it the most important motivation of the options listed. Three-fifths and nearly one-half of dealers pointed to tax considerations and ease in establishing and maintaining short positions, respectively, as very important reasons. These three motivations were also most frequently cited as very important in the March 2014 survey.

Dealers were asked to characterize the composition of the hedge book for client swaps.[6] Responses revealed the following:

- Four-fifths of respondents reported that their firm's hedge book for client swaps relies either to a considerable extent or to some extent on offsetting client trades with holdings of cash securities. Fractions of dealers ranging between three-fifths and two-thirds indicated reliance to a similar extent on offsetting trades between client portfolios, on offsetting trades between clients and external swap dealers, and on offsetting client trades with exchange-traded futures and derivatives. Nearly one-half of respondents reported reliance only to some extent on offsetting trades between clients and other lines of business within the firm.
- Most dealers indicated that the composition of their firm's hedge book has remained broadly unchanged since March 2014.[7]

With respect to dealer management of counterparty risk associated with synthetic PB, responses to the special questions revealed the following:

- All respondents pointed to the collection of initial and variation margin as either the most important or the second most important control in managing counterparty exposure to swap clients. Two-thirds of respondents also pointed to limits on long-short gross notional exposure as an important control, and one-

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[5] Respondents were asked to judge the importance of each of these possible motivations: tax considerations, access to foreign markets, ease in establishing and maintaining short positions, avoidance of limitations on rehypothecation of collateral, availability of greater leverage, ease in adjusting exposures, ease in establishing exposure to non–dollar denominated assets in dollars, and "other."

[6] The hedge book is the portfolio of offsetting positions used to manage the market risk of swaps written pursuant to synthetic PB activity. Respondents were asked about the importance of various sources of offsetting trades in constructing the hedge book. The list of sources included offsetting trades between client portfolios, offsetting trades between clients and other lines of business within the firm, offsetting trades between clients and external swap dealers, offsetting client trades with exchange-traded futures and derivatives, and offsetting client trades with holdings of cash securities.

[7] On net, small fractions of respondents indicated greater reliance on offsetting trades between clients and external swap dealers, offsetting client trades with exchange-traded futures and derivatives, and offsetting trades between clients and other lines of business within the firm.

third reported limits based on stress testing or potential future exposure (PFE).[8] More than one-half of respondents pointed to client net financing balances held in prime brokerage or to client assets held in custody as the second or third most important control.

- On net, one-third of dealers reported that initial margins posted by hedge fund clients on swaps referencing single-name equities had increased somewhat since March 2014. Smaller net fractions of respondents indicated that initial margin on swaps referencing equity indexes and on swaps referencing bespoke equity portfolios had increased somewhat.
- Two-fifths of respondents indicated that initial margin on swaps referencing single-name corporate bonds and on swaps referencing bespoke portfolios of corporate bonds had increased somewhat since March 2014. Interpretation of this finding is subject to the caveat that synthetic financing of corporate debt is less widely used than synthetic financing of equities.[9]

This document was prepared by Michael Gordy, Division of Research and Statistics, 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.

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[8] The set of choices offered in the survey did not include stress testing or PFE but did include "other." Respondents pointed to these model-based limits on counterparty risk via text response alongside "other."

[9] The subsample of dealers that provided responses to questions on initial margin on swaps referencing corporate bonds was only half as large as the subsample that provided responses to questions on initial margin for swaps referencing equities. Dealers that are not active in providing swaps of a given type reported "n/a" on the survey question pertaining to posting of initial margin on such swaps and therefore were excluded from the denominator in the reported fraction.