The December 2018 Senior Credit Officer Opinion Survey on Dealer Financing Terms

Summary

The December 2018 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 clients' exposures and positioning with respect to emerging markets and the effects of the turmoil in emerging markets earlier this year on the quantity and terms of financing offered to clients. The 23 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 November 6, 2018, and November 19, 2018. The core questions asked about changes between September and November 2018.[1]

Core Questions

(Questions 1–79)[2]

Responses to the core questions in the December survey offered a few insights on recent developments in dealer-intermediated markets. With regard to the **credit terms applicable to, and mark and collateral disputes with, different counterparty types across the entire range of securities financing and OTC derivatives transactions**, responses to the core questions showed the following:

- About one-third of dealers indicated an increase in the amount of resources and attention devoted to the management of concentrated credit exposure to central counterparties and other financial utilities over the past three months (see the exhibit "Management of Concentrated Credit Exposures and Indicators of Supply of Credit").

[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.

- In providing credit to their clients, respondents reported that price and nonprice terms were unchanged for most classes of counterparties. Small fractions of respondents reported a tightening in price terms to their nonfinancial corporation clients but an easing in nonprice terms to their trading real estate investment trust (REIT) clients.
- A small fraction of respondents reported that efforts by trading REIT clients to negotiate more-favorable price and nonprice terms had increased somewhat over the past three months.
- A net fraction of roughly one-fifth of respondents indicated that the volume and duration of mark and collateral disputes with other dealers had increased somewhat. Increases in the volume of disputes with hedge funds, mutual funds, and insurance companies were also noted by a small fraction of respondents.

With respect to clients' **use of financial leverage**, on net, dealers indicated little change over the past three months (see the exhibit "Use of Financial Leverage") for all classes of counterparties.

With regard to **OTC derivatives markets**, responses showed the following:

- Initial margin requirements on OTC derivatives were basically unchanged, on net, for average and most-favored clients.
- Roughly one-fifth and one-sixth of respondents indicated that the volume of mark and collateral disputes had increased on interest rate and equity contracts, respectively.

With respect to **securities financing transactions**, respondents indicated the following:

- A small net fraction of dealers indicated a decrease in funding demand for equities, while about one-fifth of dealers reported an increase in funding demand for agency residential mortgage-backed securities (RMBS) over the past three months (see the exhibit "Measures of Demand for Funding and Market Functioning"). A small net fraction of dealers also reported an increase in the funding demand for non-agency RMBS and consumer asset-backed securities.
- Demand for term funding with a maturity greater than 30 days was reported to be little changed across all asset classes.
- Small fractions of respondents reported an increase in the maximum amount of funding for equities. Small fractions of respondents reported an increase in effective financing rates (spreads over relevant benchmark) for agency RMBS. Effective financing rates for other asset classes were reportedly little changed.

- Roughly one-fifth of dealers reported a deterioration in liquidity and functioning for commercial mortgage-backed securities in the past three months.[3] The liquidity and market functioning for other asset classes was reported to have been generally unchanged.

Special Questions on Exposures and Positioning with Respect to Emerging Markets (Questions 81–87)

The market turmoil earlier this year in selected emerging market economies (EMEs) reportedly weighed on global investor risk sentiment and led to concerns on the part of market participants about slowing growth outside the United States. In the special questions for the survey this quarter, we asked about clients' exposures and positioning with respect to emerging markets and the effects on the quantity and terms of financing offered to clients.

About three-fourths and two-thirds of the respondents reported that their hedge fund and mutual fund clients, respectively, have some exposure to emerging markets. About one-half of the respondents reported that the other client types—including exchange-traded products (ETPs), pension plans and endowments, insurance companies, separately managed accounts (SMAs), and nonfinancial corporations—have some exposure to emerging markets.

Dealers were asked to rank the **instruments most heavily used by clients** of each type to gain or manage exposure to emerging markets. The set of instruments include foreign exchange cash (for example, spot foreign exchange), foreign exchange derivatives (for example, foreign exchange swaps), equity cash (for example, stocks), equity derivatives (for example, futures), debt cash (for example, bonds), and debt derivatives (for example, interest rate swaps).

- The instruments used to gain or manage exposure to emerging markets varied across client types, but foreign exchange cash and foreign exchange derivatives were the most popular instruments, followed by debt cash and debt derivatives. Equity instruments were less frequently used.

- Hedge funds and nonfinancial corporations use foreign exchange instruments a bit more frequently than debt instruments, while other types of clients use foreign exchange and debt instruments in roughly equal proportions.

[3] 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 markets themselves. This question was not asked with respect to equity markets in the core questions.

- Concerning the choice between cash or derivative instruments, hedge funds use derivative instruments more frequently, while ETPs, mutual funds, pension funds and endowments, insurance companies, and SMAs use cash more frequently. Nonfinancial corporations are equally likely to use derivatives and cash instruments.

With respect to **clients' positioning in emerging markets**, dealers reported the following:

- With respect to current net positions in emerging markets, about two-fifths to three-fifths of respondents reported that, for client types of ETPs, mutual funds, pension plans and endowment, and insurance companies, either most clients are net long or more clients are net long than net short. This share declines to one-fourth for SMAs.[4]

- With regard to changes in net positioning since the beginning of 2018, respondents indicated that most client types are more likely to have increased short positions or decreased long positions or both in emerging markets than the reverse. In particular, two-thirds of respondents indicated that their hedge fund clients were more likely to have increased short positions. For other client types, the fraction of respondents reporting increases in short positions ranged from one-fifth for mutual funds, pension plans, and endowments to one-third for SMAs.

With respect to the **effects of emerging markets on the quantity and terms of financing offered to clients**, dealers indicated the following:

- Nearly all respondents with clients who are net long in emerging market assets indicated that collection of initial and variation margin is the most important control in managing counterparty exposure to those clients. Limits on long-short gross notional exposure and clients' net financing balances held in prime brokerage accounts were each cited as important by nearly one-half of respondents.

- Nearly all respondents reported that the turmoil in emerging markets earlier this year has not affected the total amount of funding they make available to clients.

- For hedge fund clients with significant emerging market exposure, roughly one-third of respondents reported a tightening in price and nonprice terms. Roughly one-fifth of respondents, on net, reported a tightening in price and nonprice terms

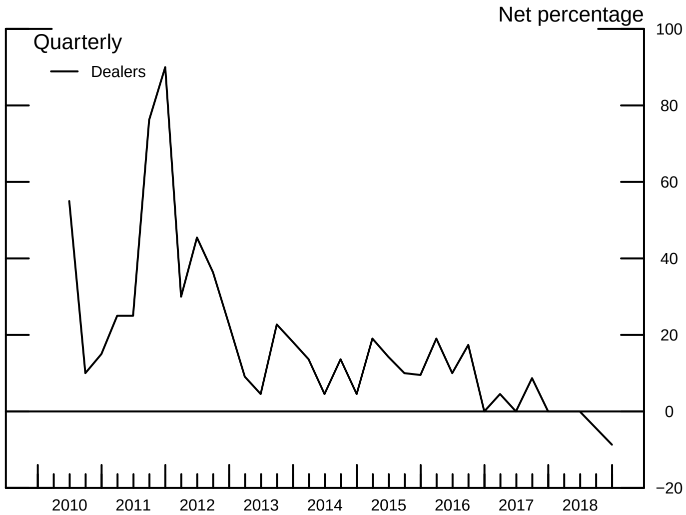
[4] In the survey, long positions in exchange rate instruments are defined as those that rise in value from an appreciation of EME currency against the dollar, long positions in debt (equity) instruments are those that rise in value from a rise in debt (equity) prices, and a client being "net long" indicates that the client has more long than short positions in dollar terms.

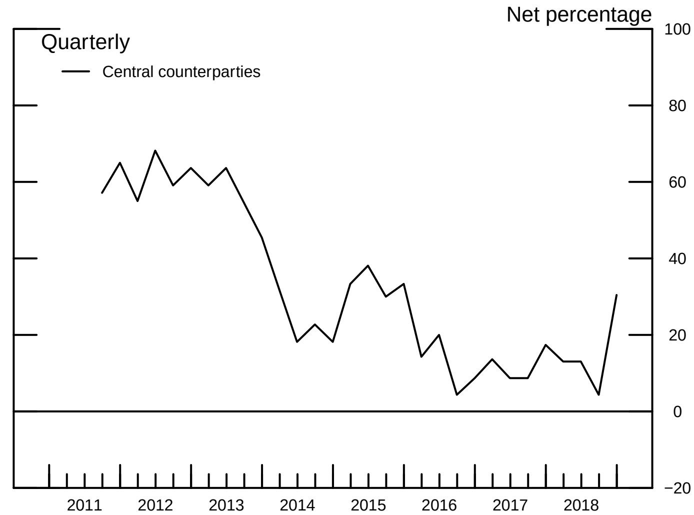
for SMA and nonfinancial corporate clients with significant emerging market exposure.

This document was prepared by Mary Tian, 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 Capital Markets Function, the Statistics Function, and the Markets Group at the Federal Reserve Bank of New York.

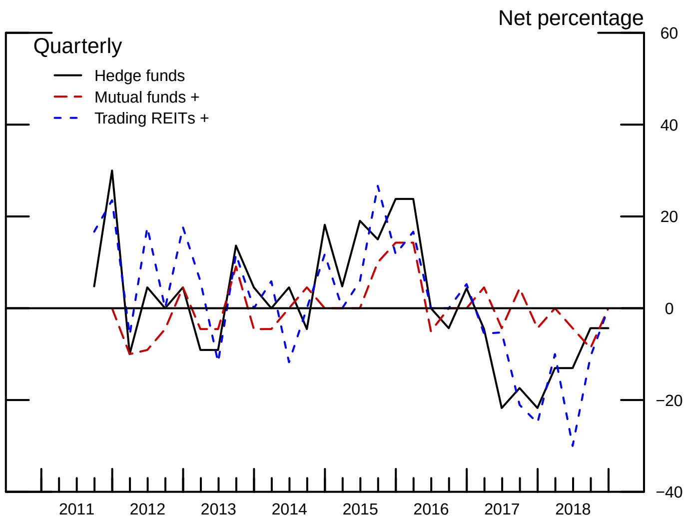
Management of Concentrated Credit Exposures and Indicators of Supply of Credit

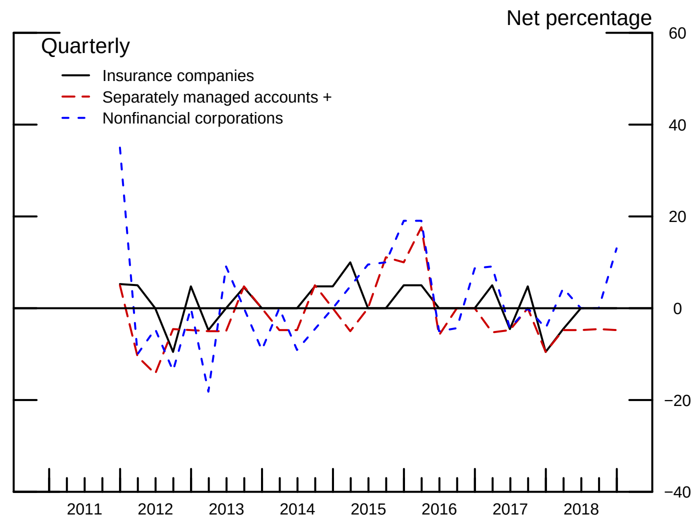
Respondents increasing resources and attention to management of concentrated exposures to the following:



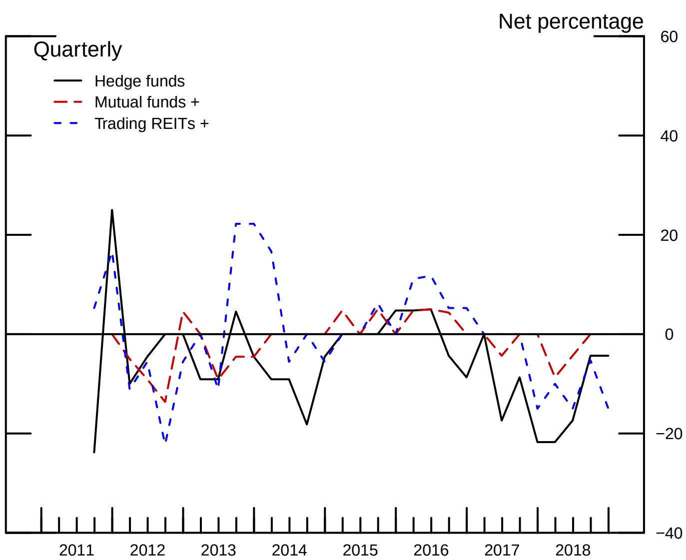


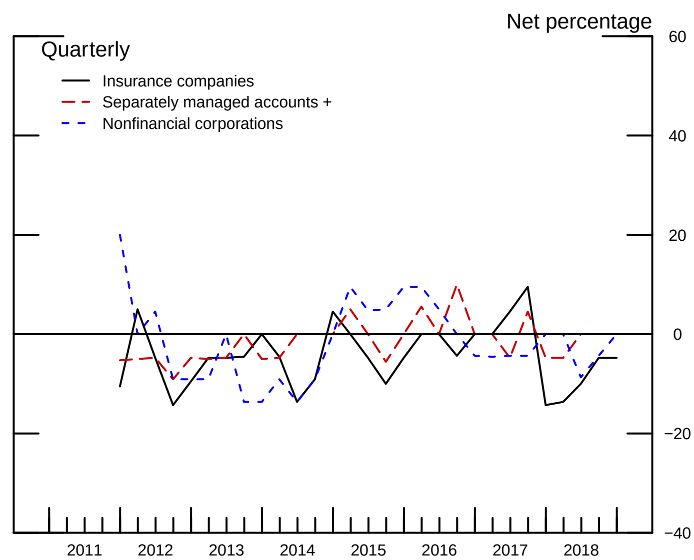
Respondents tightening price terms to the following:





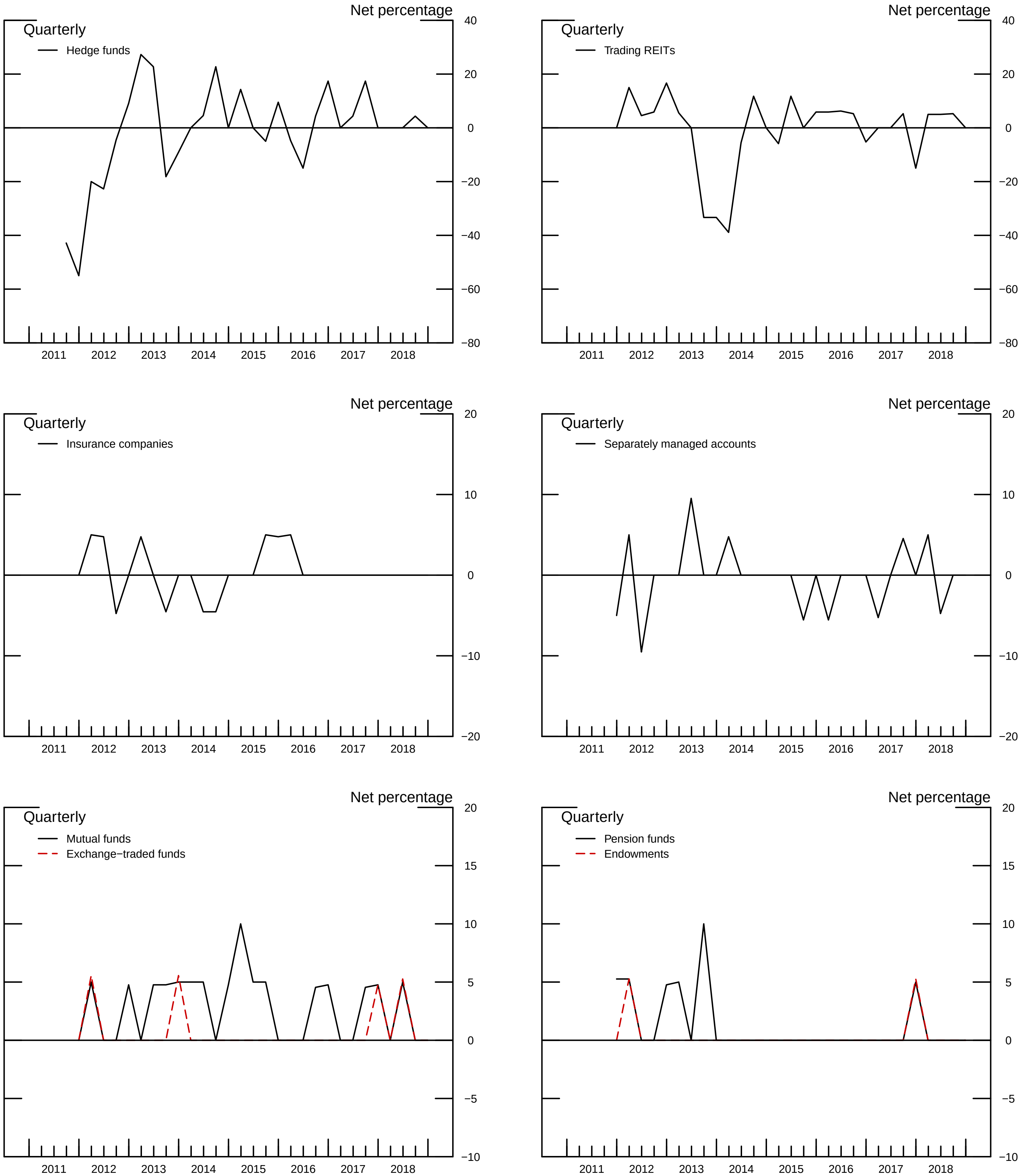
Respondents tightening nonprice terms to the following:





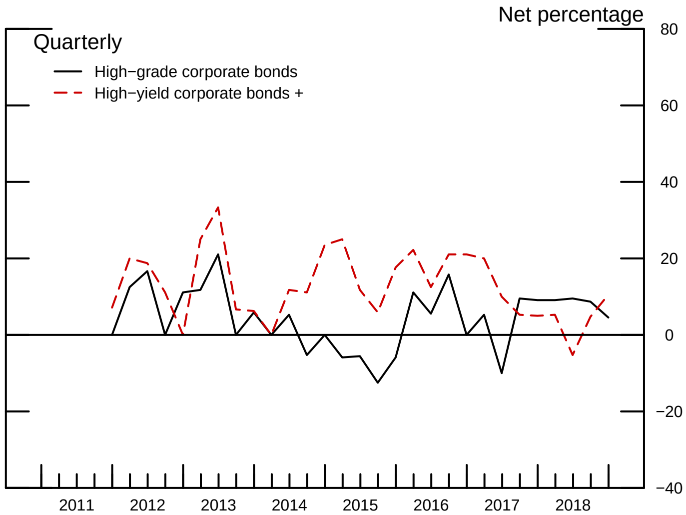
Use of Financial Leverage

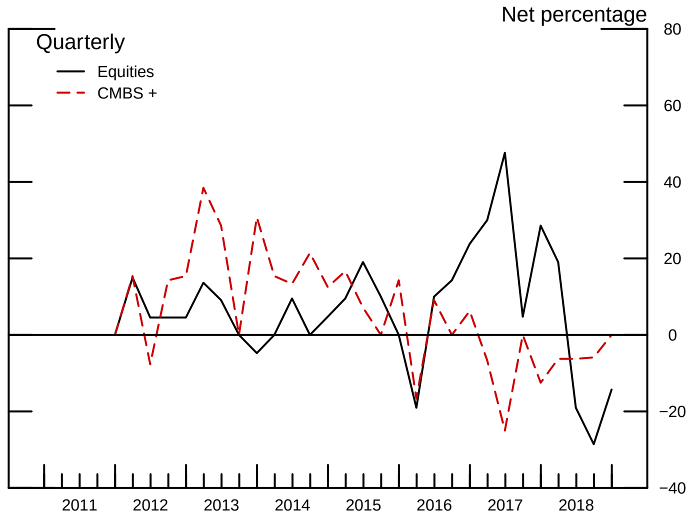
Respondents reporting increased use of leverage by the following:

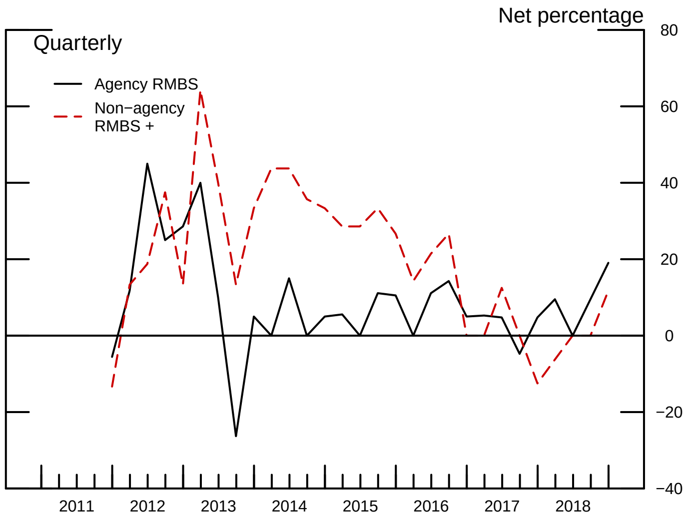


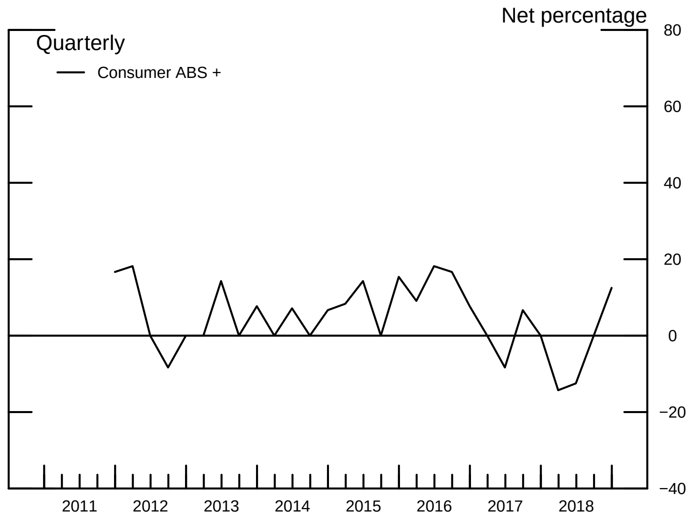
Measures of Demand for Funding and Market Functioning

Respondents reporting increased demand for funding of the following:









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