The June 2017 Senior Credit Officer Opinion Survey on Dealer Financing Terms

The June 2017 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 OTC derivatives that are not centrally cleared (uncleared swaps) and are affected by new margin rules. 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 between May 9, 2017, and May 22, 2017. The core questions asked about changes between March 2017 and May 2017.[1]

Core Questions

(Questions 1–79)[2]

Responses to the core questions in the June survey overall suggested an increased supply of and demand for dealer facilitation in OTC derivatives and securities financing 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 revealed the following:

- About one-fifth of respondents reported an easing in price and nonprice terms for their hedge fund clients. Among the dealers that indicated easing of terms, more aggressive competition from other institutions was cited as the most important reason, followed by improvement in general market liquidity and functioning. Almost one-third of dealers noted an increase in the intensity of efforts by hedge fund clients to negotiate more favorable terms. Price and nonprice terms were basically unchanged for all other classes of counterparties.
- A small fraction of dealers reported an increase in the volume of mark and collateral disputes with dealers and other financial intermediaries.

With respect to the **use of financial leverage**, on net, dealers indicated little change over the past three months for all classes of counterparties.

[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.

With regard to **OTC derivatives markets**, dealers reported the following:

- Initial margin requirements on OTC derivatives were basically unchanged, on net, for average and most-favored clients.
- Small net fractions of dealers responded that the volume, duration, and persistence of mark and collateral disputes have increased in OTC derivatives, especially in foreign exchange and interest rate contracts.

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

- One-fifth, two-fifths, and one-fourth of dealers noted a decrease over the past three months in financing rates (collateral spreads over the relevant benchmarks) for average and preferred clients in agency residential mortgage-backed securities (RMBS), non-agency RMBS, and commercial mortgage-backed securities (CMBS), respectively. One-fifth of dealers responded that the financing rates for average clients in equities have decreased. Smaller net fractions of dealers also reported that financing rates have decreased for high-yield corporate bonds and consumer asset-backed securities.
- One-third and one-fifth of respondents reported that haircuts have decreased for securities financing transactions collateralized by non-agency RMBS and CMBS, respectively. Small net fractions of dealers noted increases in maximum amounts of funding available for equities and non-agency RMBS, as well as increases in maximum maturities allowed for agency RMBS.
- Nearly one-half of dealers reported an increase in demand for funding for equities, while one-fourth reported a decrease in demand for funding for CMBS. A smaller fraction noted an increase in demand for term funding with a maturity greater than 30 days for high-yield corporate bonds.
- Two-fifths of dealers responded that the liquidity and market functioning for non-agency RMBS have improved over the past three months. One-fifth, on net, reported such improvements in markets for high-yield corporate bonds and CMBS.

Special Questions on Uncleared Swaps

(Questions 81–92)

Title VII of the Dodd-Frank Act requires financial regulators to establish new minimum margin requirements for uncleared swaps. In 2015, the U.S. prudential regulators and the Commodity Futures Trading Commission adopted final rules that began to be implemented in September 2016.[3] Under the new rules, parties involved in uncleared swap transactions must exchange initial margin (IM) when a trade is established and

[3] The term “prudential regulators” refers to the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Farm Credit Administration, and the Federal Housing Finance Agency.

provide variation margin (VM) to each other on a daily basis over the life of the derivatives contract.[4]

In the special questions of the survey this quarter, dealers were queried about the overall use and pricing of uncleared swaps that are affected by the new rules and their experiences in adopting the new VM requirement. The next sections summarize the responses from roughly four-fifths of dealers who indicated that they make markets in uncleared swaps and have thus responded to the special questions.

With respect to **how the overall use and pricing of uncleared swaps that are affected by the new rules have changed since September 2016**, responses to the special questions showed the following:

- A small fraction of survey respondents indicated that their clients' transaction volumes in uncleared swaps have decreased somewhat.
- One-fifth of dealers responded that their own transaction volume in uncleared swaps has decreased somewhat.
- Dealers reported no change in the prices that they quote to their clients in uncleared swaps.

With respect to **dealers' experiences in adopting the new VM requirement**, responses to the special questions revealed the following:

- A net fraction of about one-fifth of respondents reported that, within the transactions that are affected by the new rules, the fraction of their clients' uncleared swap transactions that are collateralized by VM has increased since September 2016. A majority of those that indicated an increase reported a 0 to 25 percentage point change, as measured by gross notional amount outstanding.
- When asked to identify which types of clients they are relatively less likely to be exchanging daily VM with, one-fifth of dealers pointed to mutual funds, exchange-traded funds, pension plans, endowments, and separately managed accounts established with investment advisers.[5] The most cited reason was that these clients have not yet established or updated necessary credit support annexes to cover daily VM, followed by the lack of segregation arrangements in place. When asked about the type of VM agreement used among clients that already have the necessary agreements and documentation, three-fourths of respondents

[4] Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Farm Credit Administration; and Federal Housing Finance Agency (2015), "Margin and Capital Requirements for Covered Swap Entities," final rule (Docket No. R-1415), *Federal Register*, vol. 80 (November 30), pp. 74839–74914, https://www.federalregister.gov/documents/2015/11/30/2015-28671/margin-and-capital-requirements-for-covered-swap-entities; Commodity Futures Trading Commission (2016), "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," final rule and interim final rule, *Federal Register*, vol. 81 (January 6), pp. 635–709, http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2015-32320.

[5] Two-fifths of respondents chose "Other," but their text responses generally indicated nonfinancial corporations that are not subject to the new margin requirements.

indicated that between 0 and 25 percent of such clients use the ISDA [International Swaps and Derivatives Association] 2016 Variation Margin Protocol.

- Two-fifths and one-fifth of dealers responded that they are less likely to exchange daily VM for foreign exchange derivatives (excluding physically settled foreign exchange forwards and swaps) and commodity derivatives, respectively, relative to other types of uncleared swaps. Dealers overall pointed to the lack of operational readiness as the most important reason.

With respect to the **mark and collateral disputes on VM**, respondents indicated the following:

- Two-fifths of dealers reported that the volume of mark and collateral disputes on VM has increased somewhat since September 2016.
- Three-fifths of dealers responded that, on average, it takes more than two days but less than a week to resolve a mark and collateral dispute on VM. One-third indicated two days or fewer.

This document was prepared by Yesol Huh, 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.