Box 4

Recent trends in credit terms and conditions in euro-denominated securities financing and over-the-counter derivatives markets based on information from the SESFOD survey

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SESFOD **is a quarterly survey launched in 2013 as a Eurosystem initiative to collect information on changes in credit terms and conditions on euro-denominated securities financing and over-the-counter (OTC) derivatives markets.** The survey is based on 28 large banks, comprising 14 euro area banks and 14 banks with head offices outside the euro area. Banks answer questions at a quarterly frequency regarding how they changed the terms and conditions (both price and non-price) offered to their clients, as well as providing a ranking of the motivations underlying their decisions. The information collected in the survey is useful to assess financial stability, market functioning and the monetary policy transmission mechanism. The survey provides useful insights into the ability of financial intermediaries to secure funding and hedge risks. Buoyant conditions and loose terms may lead to high leverage, while excessively tight terms may provide insights into possible market dysfunctionalities.

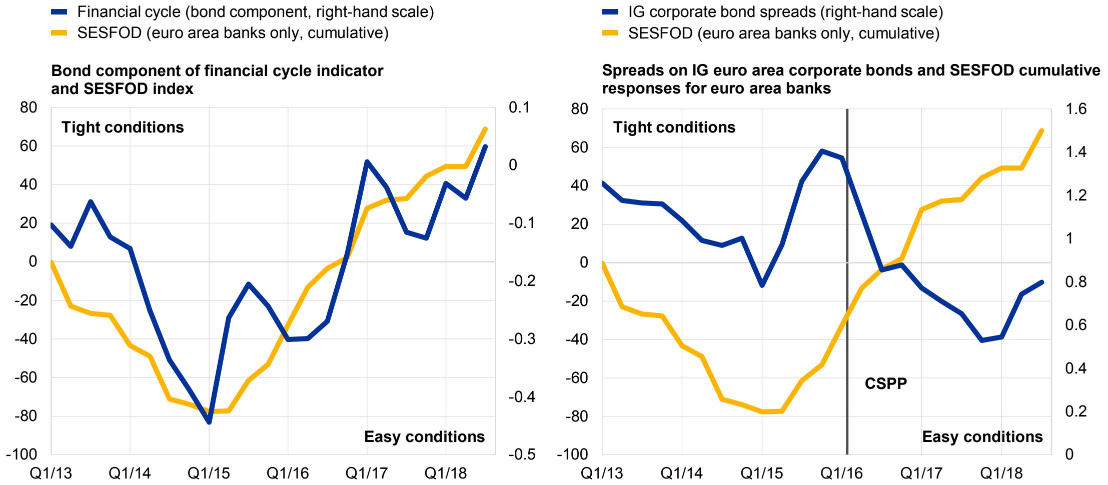
This box presents an index summarising financing and hedging conditions, which is derived by aggregating the changes reported in SESFOD. According to such an index, financing and hedging conditions have tightened since mid-2015, following two years of progressive easing (see Chart A, left panel). Evidence from SESFOD is in line with the “financial cycle” indicator (the blue line in the left panel of **Chart A**), which measures broad financial conditions in bond markets.

Chart A

SESFOD index aligned with broad bond market developments, while non-financial corporates benefited from more accommodative financial conditions since CSPP implementation

Bond component of the financial cycle indicator and SESFOD index (left panel), bond spreads on investment-grade euro area corporate bonds and SESFOD cumulative responses for euro area banks (right panel)

(Q1 2013-Q3 2018, SESFOD index, financial cycle indicator, bond spreads in annual percentages)



Sources: SESFOD, Markit iBoxx indices and ECB calculations.
Notes: The SESFOD index is computed by averaging the changes in credit terms and conditions from SESFOD across counterparties and then cumulating the average changes. The SESFOD index is set at 0 in Q4 2012. The index only includes euro area financial intermediaries. The financial cycle indicator is described in Schüler, Hiebert and Peltonen (2015). Spreads in the right panel are measured by subtracting from investment-grade (IG) yields the corresponding overnight index swap rate of the closest maturity and then re-aggregating by weighting with the bonds' outstanding amounts.

The SESFOD index was consistent with financing conditions for non-financial corporations (NFCs) until the inception of the ECB's corporate sector purchase programme (CSPP). Overall credit terms, as measured by SESFOD, and spreads on corporate bonds (where the latter are a proxy for funding conditions for NFCs) exhibited similar trends until the end of 2015. Since then, financing and hedging conditions for financial institutions have continued to tighten, while the CSPP has contributed to compressing NFC bond spreads (see **Chart A**, right panel).

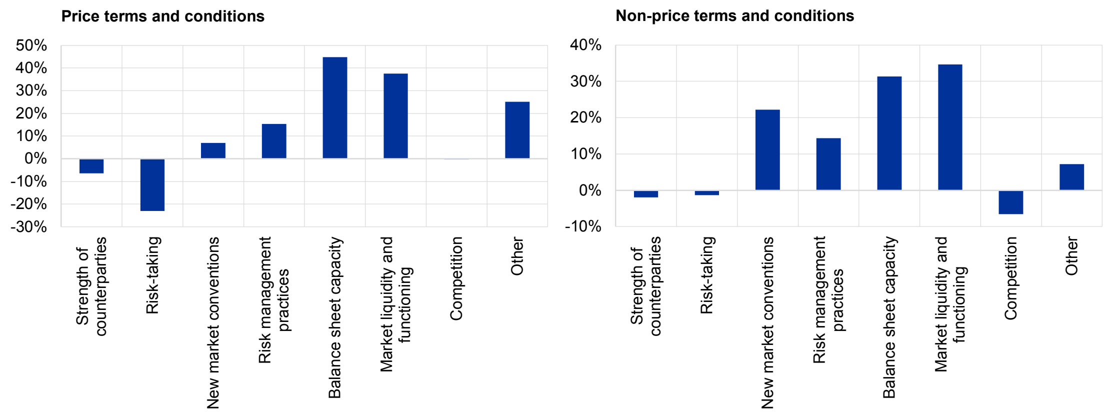
Banks reported that reduced balance sheet capacity of financial intermediaries, as well as market liquidity and functioning, were the main factors responsible for the tightening of price and non-price conditions. Regarding the non-price terms and conditions, additional factors contributing to their tightening were the adoption of new market conventions and the new risk management practices introduced after the global financial crisis (see **Chart B**). New market conventions included the protocols introduced by the International Swaps and Derivatives Association (ISDA). Risk-taking and competition contributed to the easing of the price and non-price terms and conditions, respectively.

Chart B

Tightening mainly related to liquidity conditions and balance sheet capacity

SESFOD most important motivation for net tightening: price terms and conditions (left panel); non-price terms and conditions (right panel)

(Q1 2013-Q3 2018, percentages)



Sources: SESFOD and ECB calculations.
Note: Negative values mean that the survey respondents indicated the motivation as a factor for easing terms and conditions.

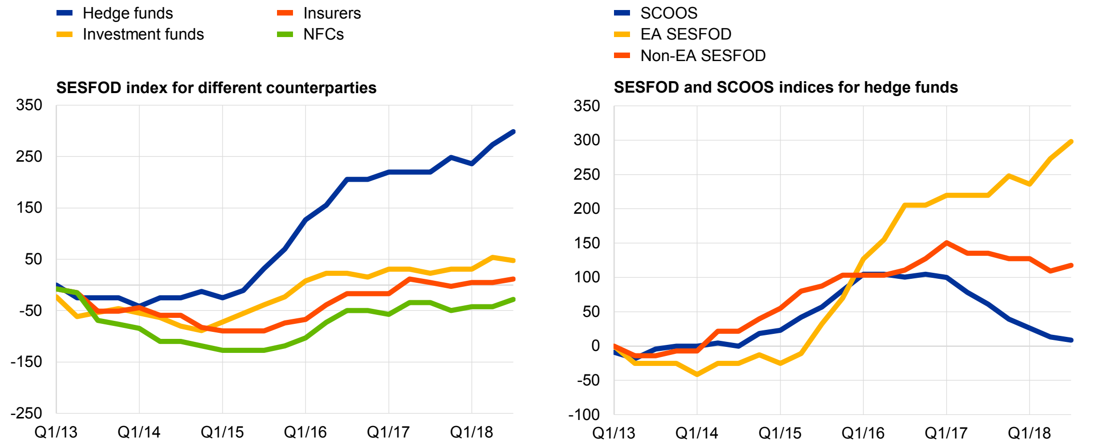
The tightening of financing and hedging conditions was particularly strong for transactions with hedge funds (see Chart C, left panel), as reported by surveyed banks. Looking across the different types of counterparty, the SESFOD survey shows that dealers changed their conditions in a heterogeneous manner. Most of the tightening in conditions was concentrated on hedge funds, followed by investment funds, while conditions eased for NFCs.

Chart C

Financing conditions have tightened for euro area hedge funds and have recently eased for US hedge funds

SESFOD index for different counterparties (left panel); SESFOD and SCOOS index for price conditions offered to hedge funds (right panel)

(Q1 2013-Q3 2018, indexed to 0 in Q1 2013)



Sources: SESFOD for the euro area, Senior Credit Officer Opinion Survey (SCOOS) for the United States and ECB calculations.
Note: Both the SESFOD and SCOOS indices were readjusted to 0 in Q1 2013.

Recently, financing and hedging conditions applied to hedge funds in the euro area have differed from those applied to hedge funds in the United States (see Chart C, right panel).

According to the US Senior Credit Officer Opinion Survey (SCOOS), the price terms and conditions of financing and hedging applied to hedge funds started to tighten in the course of 2014. The same development occurred for hedge funds in the euro area about six months later. However, price conditions in the United States started to ease after the first quarter of 2017, when competition to provide funding intensified in the United States, amid the increase in policy rates. Surveyed banks report that euro area banks and dealers have instead continued tightening price terms and conditions for hedge funds. By contrast, financial institutions headquartered outside the euro area started to ease credit conditions for euro-denominated transactions with hedge funds in 2017, in line with what happened in the United States. Regarding the non-price terms and conditions applied to hedge funds, they eased over the whole reference period in the United States, with a marked acceleration in the course of 2017, while they tightened in the euro area.