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SVERIGES RIKSBANK

Market participants' views on risks and the functioning of the Swedish fixed-income and foreign exchange markets

AUTUMN 2012

Market participants' views on risks and the functioning of the Swedish fixed-income and foreign exchange markets[1]

The Swedish financial markets are functioning relatively well, but are still affected by the international uncertainty, according to the market participants who responded to the Riksbank's risk survey in October 2012. The respondents assess that liquidity has improved slightly in the fixed-income market, while it has deteriorated somewhat in the foreign exchange market. The central bank measures presented during the summer and early autumn by the ECB, the Federal Reserve and the Bank of England are perceived to have had a calming effect on the markets. At the same time, the respondents say that uncertainty remain regarding the structural problems in the debt-ridden countries of the euro area. Therefore the majority of the respondents do not expect any change in their willingness to take risk in the coming period. Many also believe that coming regulations might increase costs and reduce liquidity in the financial markets. Some also say that the uncertainty regarding the details of the new regulations has caused the market to take a wait-and-see stance, and that the effects of some of the coming regulations have already affected pricing of financial instruments.

THE SWEDISH FINANCIAL MARKETS ARE FUNCTIONING RELATIVELY WELL BUT ARE STILL AFFECTED BY INTERNATIONAL UNCERTAINTY

Most respondents do not perceive any major changes in the way the Swedish financial markets function since the previous survey (Figure 1).[2] However, almost one third of the respondents, particularly those active in the fixed-income market, said that the markets are functioning somewhat better than they did six months ago. This is said to be mainly due to central bank measures[3], which according to the respondents have had a calming effect on the markets. This effect is partly due to that the debt-ridden countries thereby have gained more time to manage their sovereign debt problems. At the same time, other respondents say that coming regulations and lower risk appetite have meant that the market is functioning more poorly. This can primarily be noted in the trade in derivatives on the foreign exchange market, where some respondents say that the amount of transactions has declined and that the costs of trading have increased.

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[1] With effect from spring 2008 the Riksbank has sent out a risk survey twice a year to participants in the Swedish fixed-income and foreign exchange markets. The purpose of the survey is to obtain an overall picture of the view of risk in the Swedish financial markets and to gain an idea of the views on the functioning of the markets. The survey only refers to the Swedish financial system. This report describes the results of the Riksbank's risk survey where responses were received between 8 October and 23 October 2012. The Riksbank commissioned survey company Markör Marknad och Kommunikation AB to perform the survey on its behalf. The survey supplements the annual discussions the Riksbank has with its monetary and foreign exchange policy counterparties on developments in the financial markets, and the regular contacts with market participants. The autumn survey was sent out to 77 participants active in the Swedish fixed-income and foreign exchange markets. The groups surveyed are the Riksbank's monetary and foreign exchange policy counterparties (market makers) and active participants in these markets, both investors and borrowers. The response rate was 87 per cent.
[2] References to the previous, most recent or the spring risk survey all refer to the risk survey carried out by the Riksbank in March and April 2011, which covered the period October 2011 to March 2012.
[3] In particular the ECB's announcement of its purchase of treasury bonds (OMT), but also increased monetary stimulus in the United States and the United Kingdom.

According to the respondents, developments in the Swedish financial markets have been primarily driven by credit and liquidity risks (Figure 2). However, they state that there have been no major changes to these risks over the past six months. The respondents consider that trading in the markets is still affected by a relatively low risk appetite and by occasionally limited liquidity. For instance, there have been some difficulties in selling large volumes without affecting prices too much.

Figure 1. What is your assessment of the functioning of the Swedish financial markets compared to six months ago?

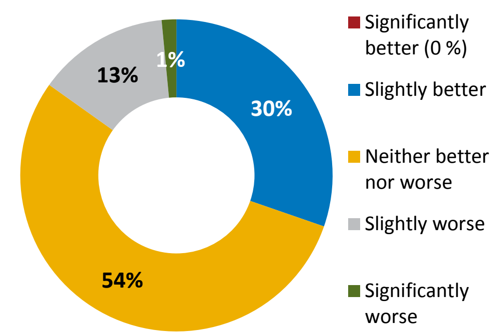
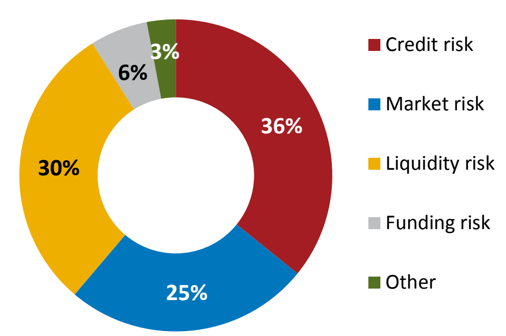


Figure 2. Which of the following risks has had most significance for developments in Swedish market functioning?[4]



The respondents are not expecting any major changes in the way the markets function, neither in the short term (Figure 3) nor the medium term (Figure 4). In general, they are expecting that the stabilisation of the euro area crisis that has taken place over the year will continue. In the longer run, they think that risk appetite will slowly increase as the economic problems in the euro area are resolved and as return requirements increase. At the same time, several respondents think that the coming changes in the financial regulations will require adjustments that may cause a decline in activity on the financial markets. However, a few respondents warn that there is still a tangible risk that the situation in the euro area could worsen. If this happens, they say that the Swedish financial market could also be negatively affected.

Figure 3. How do you foresee the functioning of the Swedish financial market in the short term (6 months)?

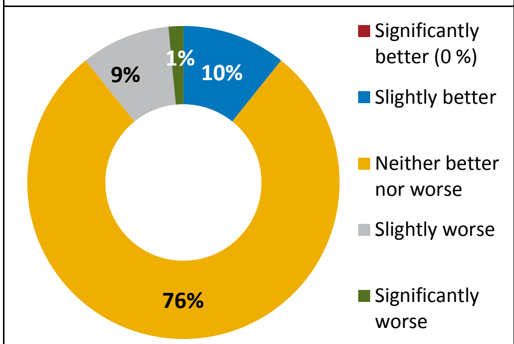
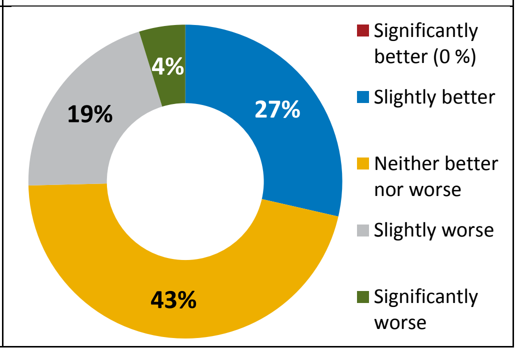


Figure 4. How do you foresee the functioning of the Swedish financial market in the medium term (6 months to 2 years)?



[4] Credit risk refers to credit risk among counterparties and issuers, market risk refers to volatility in prices and interest rates, liquidity risk refers to depth and pricing of various financial instruments and funding risk refers to one's own organisation's access to liquid funds/financing.

ACCORDING TO RESPONDENTS THE DEVELOPMENT IN THE EURO AREA IS THE GREATEST RISK FOR THE SWEDISH FINANCIAL SYSTEM

The respondents have assessed a number of risks that could entail negative consequences for the Swedish financial system if realised within the coming six months (Table 1). In general, they consider that concerns regarding sovereign debt and the economic policy in the euro area are the largest risks. These risks are thought to have increased since the previous risk survey was published.[5] The respondents say that Sweden is at risk of being affected indirectly, through weaker economic activity if the problems in the euro area worsen. They also regard the risks linked to global growth and global economic policy as severe. The probability of these being realised is thought to have increased over the past six months, mainly with regard to risks related to global growth.

Colour-coding for the scale of 1 to 8:

1	2	3	4	5	6	7	8
Very low							**Very high**

Table 1. The respondents' assessment of selected risks that can affect the Swedish financial system

Risk factor	Probability	Consequences
Sovereign debt risk in the euro area	6,1	6,2
Sovereign debt risk in other countries	4,6	5,3
Growth-related macroeconomic risks in the Baltic countries	3,5	4,2
Growth-related macroeconomic risks globally	5,2	5,2
Risks related to economic policy in Sweden	3,0	5,2
Risks related to economic policy in the euro area	6,1	5,7
Risks related to economic policy globally	5,1	5,0
Macroeconomic risks related to large surpluses or deficits on current accounts	4,9	4,7
Credit risks among Swedish households	4,1	6,0

The participants are still concerned about the consequences if Swedish households were to experience problems repaying their loans. However, the probability of this happening is perceived to be relatively low. The probability of Swedish economic policy causing problems in the Swedish financial system remains low, according to the market participants. The same applies to economic developments in the Baltic countries.

[5] The question has been reformulated to some extent since the spring risk survey. The difference is that the risks have gained a clearer geographical breakdown. This means that the responses are not entirely comparable.

UNCHANGED WILLINGNESS AND ABILITY TO TAKE RISK FOR MOST RESPONDENTS

Half of the respondents assess that their willingness to take risk has been unchanged over the past six months (Figure 5). The majority also states that their risk mandate has remained constant during the period (Figure 7). This is mainly explained by that the overall economic problems in the euro area still remains, which means that the market situation has not changed. The respondents who have increased their willingness to take risk (primarily investors) state the fact that the market is now functioning somewhat better than before as the main reason for this. A few respondents also mention the low return on safe assets as a reason, as this means they have to take more risk to attain their return target. The respondents who state a decreased willingness to take risk (primarily borrowers) instead say that poorer growth prospects have been the main contributory factor.

Most respondents are not expecting any change in either their willingness to take risk (Figure 6) or their risk mandate (Figure 8) during the coming six months. They expect that the uncertainty over the economic problems in the euro area will continue to affect the financial markets for a long period of time. However, almost one quarter of the respondents believe that their willingness to take risk will increase somewhat in the coming six months. Most of these respondents claim that this is because they are expecting some progress in the sovereign debt problems in the euro area and the United States in the coming period.

Figure 5. How has your willingness to take risk changed compared to six months ago?

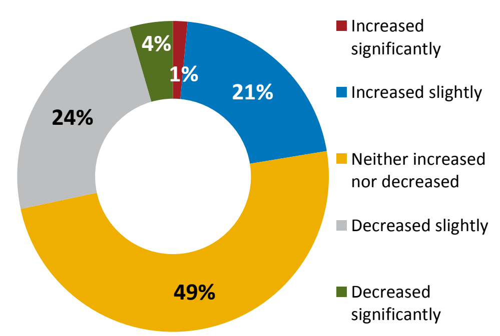


Figure 6. How do you foresee your willingness to take risk over the coming six months?

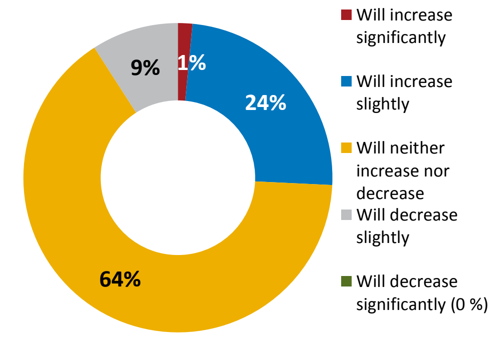


Figure 7. How has your scope/mandate to take risk changed compared to six months ago?

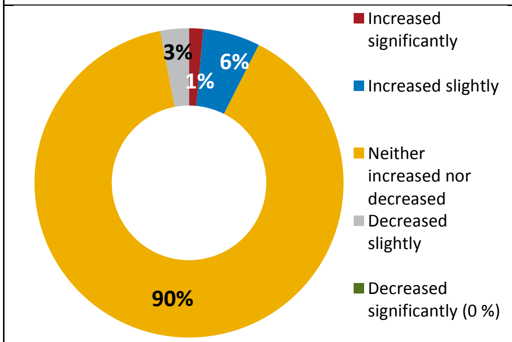
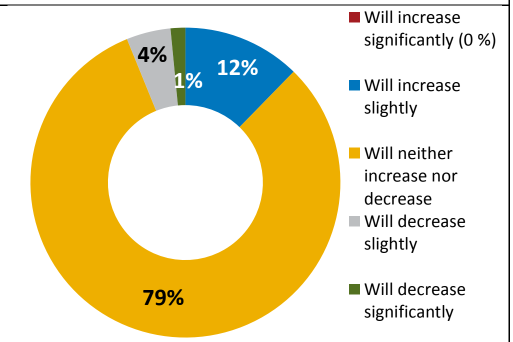


Figure 8. How do you foresee your scope/mandate to take risk over the coming six months?



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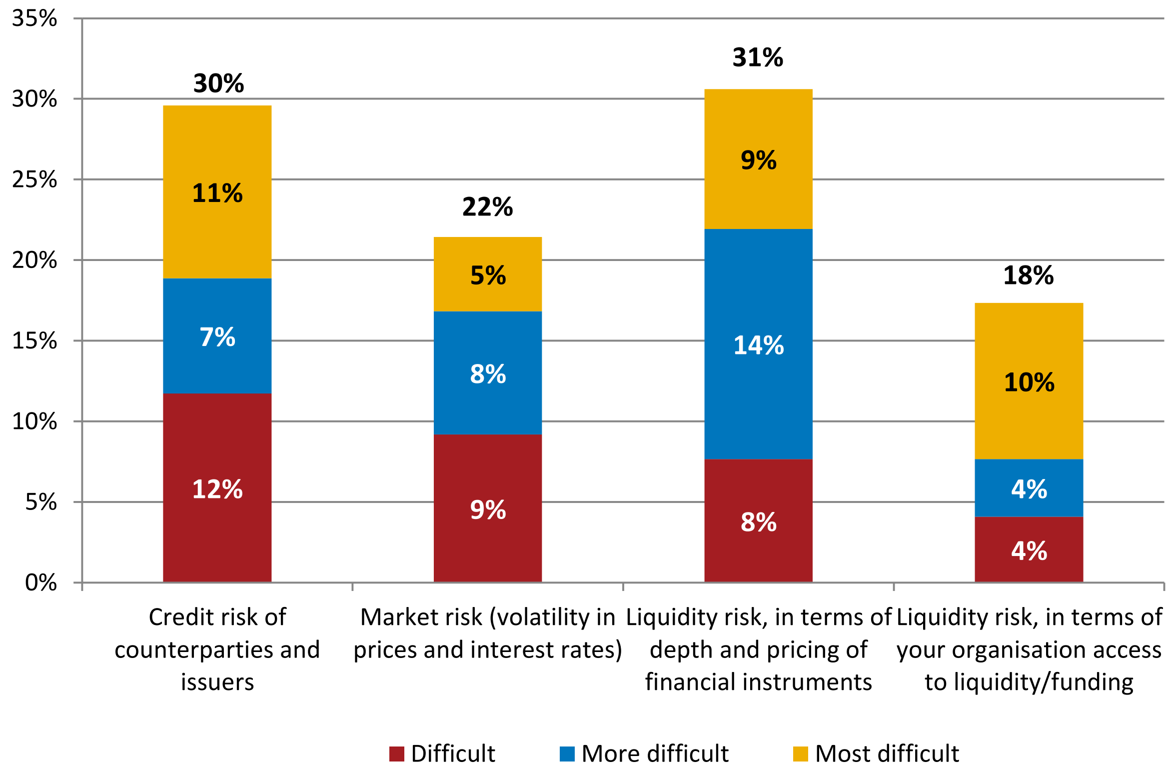
LIQUIDITY RISK AND CREDIT RISK ARE THE MOST DIFFICULT TO MANAGE[6]

Credit risk among counterparties and issuers and liquidity risks related to order depth and pricing[7] are the risks most respondents cite as the most difficult for their organisation to manage (Figure 9). The responses remain largely unchanged from the spring survey. In general, investors state that they are most sensitive to increased liquidity risk linked to order depth and pricing, while borrowers to a greater extent state that they are sensitive to increased credit risks. The market makers state that they are equally sensitive to both risks.

Another type of liquidity risk relates to the organisations access to. This is the risk that the smallest number of respondents has stated as difficult to manage. However, it has considerable significance for those who mention it. These respondents are primarily borrowers.

Market risk is another risk that relatively few respondents state as difficult to manage. Compared with other risks, the respondents consider market risk to have relatively little significance. However, it is not possible to see any difference between the different types of respondents with regard to views on market risk.

Figure 9. The respondents' assessment of the risks that would be most difficult for their organisations to manage if they increase, percentage of responses.



[6] The respondents were asked to state up to three risks that would be difficult for their organisation to manage. They were asked to rate these risks from one to three, where one meant that the risk would have great significance and three meant that it would have less significance for their organisation.
[7] The order depth reflects how many buyers and sellers there are on the market. Pricing reflects the difference between the purchase and selling prices on the market.

Open-ended questions related to the functioning of the fixed-income and foreign exchange markets

The Riksbank also posed a number of open-ended questions to the market participants. These questions concern topics that are of particular relevance at present.

MARKET PARTICIPANTS ARE CONCERNED THAT COMING REGULATIONS WILL LEAD TO POORER FUNCTIONING OF FINANCIAL MARKETS IN SWEDEN

The Riksbank asked the participants how they expect future regulations to affect their business operations and the functioning of the financial markets.

Many respondents feel that the new capital adequacy requirements in Basel III[8] and the regulation of the OTC market[9] for derivatives through EMIR[10] can lead to poorer functioning and lower liquidity in the derivatives market. This will make it more expensive to manage risks through financial derivatives, which could result in companies and financial institutions refraining from protecting themselves against financial risks. Due to this, the respondents consider that the risks in the Swedish financial system may increase.

Several respondents also say that the new capital adequacy requirements in Basel III will cause the banks to reduce their lending to the corporate sector. Instead, companies will to a greater extent use corporate bonds to obtain funding. This development is welcomed by investors. At the same time, other market participants warn that smaller companies do not have the capacity to issue bonds. Some participants also consider that there is a problem if credit risks move from the banking system to individual investors.

There are mixed opinions regarding the effects of the liquidity regulations in Basel III. Investors welcome the fact that the regulations will probably entail an increased supply of debt instruments with longer maturities. At the same time, some other market participants are worried that the regulation could lead to less liquidity on the short-term fixed-income market.

[8] Basel III is an international regulatory framework for banks that regulates capital adequacy, that is, how much capital a bank must hold in relation to the risks it takes, and liquidity management. Basel III is to be implemented gradually up to 2019. See also the article on Basel III in Financial Stability Report 2010:2, Sveriges Riksbank.
[9] OTC stands for "Over The Counter" and refers to trade that takes place outside of a central marketplace.
[10] The EMIR is an EU regulation that governs the management of counterparty risks in OTC derivative transactions and the requirement to report derivative transactions. The EMIR also regulates central counterparties and trade repositories in the EU. The regulation will probably be fully implemented by the end of 2013.

THE MAJORITY OF THE RESPONDENTS HAS CONFIDENCE IN STIBOR, BUT SOME STATE THAT THE REFERENCE RATE IS A LITTLE TOO HIGH

The Riksbank asked the market participants for their views on the calculation of STIBOR.[11] Most of them say that they have confidence in the Swedish reference rate. However, some perceive that there are problems. The problems mainly concern the lack of transparency regarding how the rate is set and the fact that it is only a few participants that are involved in the process, which gives each individual participant a relatively large influence. Some respondents also state that it is a problem that the participants' STIBOR bids cannot be traded on, as this reduces the incentive to make correct bids. Although the respondents in general have confidence in STIBOR, several consider that it has been set a little too high in relation to market prices, of for example currency forwards and STINA swaps[12], primarily those with 3-month maturities.

NO MAJOR EFFECTS ON SWEDISH MARKETS FROM LOW INTEREST RATES ABROAD

The respondents see no major problems for the Swedish financial markets resulting from the low interest rates abroad. However, some of them state that they have seen an increased interest in Swedish assets from foreign investors. This strengthens the Swedish krona and also pushes down Swedish interest rates. A few respondents consider that this can create problems for the Swedish export sector in the long run, and lead to increased indebtedness among Swedish households. Some also point out that persistent low interest rates can cause investors to take too much risk as they look for higher-risk assets in their search for yield.

MARKET MAKERS WILLINGNESS TO TAKE RISK REMAINS UNCHANGED

The respondents perceive that market makers' willingness to take risk remains unchanged, which means that it is still lower than prior to the financial crisis in 2008. As a result, they perceive the markets to function worse, with lower turnover and a greater spread between purchase and selling prices. According to the respondents, this makes it more difficult to sell large positions today than it was prior to the financial crisis. However, the problems are limited and in general they consider that the markets are functioning satisfactorily.

INCREASED INTEREST IN SWEDISH KRONA GOOD FOR LIQUIDITY IN THE KRONA FOREIGN EXCHANGE MARKET

In general, the respondents see no major risk of negative effects on the krona foreign exchange market from the increased interest in the Swedish krona. Instead they say that this interest has created better liquidity in the market. However, some respondents warn that the volatility in Swedish interest rates and exchange rates could increase if interest in the krona suddenly wanes and large outflows arise. Many respondents think that the krona has been somewhat undervalued earlier and therefore consider the stronger exchange rate to be reasonable. At the same time however, several of them point out that a strong krona exchange rate can have a negative effect on Swedish export companies.

[11] STIBOR (Stockholm Interbank Offered Rate) is a daily reference rate based on the interest rates for unsecured loans that banks offer to one another. STIBOR is used as a reference for rate setting or pricing of derivative and bond contracts.
[12] STINA stands for STIBOR T/N Average. A STINA contract is an agreement lasting up to a maximum of one year to pay or receive the difference between an agreed fixed rate of interest and a variable overnight rate (STIBOR T/N).

Liquidity in the Swedish fixed-income and foreign exchange markets[13]

The risk survey contains a number of questions on specific instruments, to give an idea of how the various sub-markets have functioned over the past six months. Market participants are asked to rate how the liquidity conditions has been for specific instruments, on the basis of how easy it has been to sell large volumes and on how large the difference between the purchase and selling prices has been. They were asked to rate according to a scale of 1 to 5, where 1 means poor and 5 means excellent. According to the respondents, liquidity in most instruments on the Swedish fixed income market has improved somewhat over the past six months. Unlike the fixed-income market, the liquidity in most instruments on the krona foreign exchange market is perceived to have deteriorated somewhat, although the change is small. However, fewer respondents consider that the Swedish foreign exchange market is functioning worse than adequately.

MARKET PARTICIPANTS' ASSESSMENT OF THE LIQUIDITY IN INSTRUMENTS ON THE SWEDISH FIXED INCOME MARKET[14]

Figure 10. What is your view of liquidity with regard to treasury bills over the past six months?

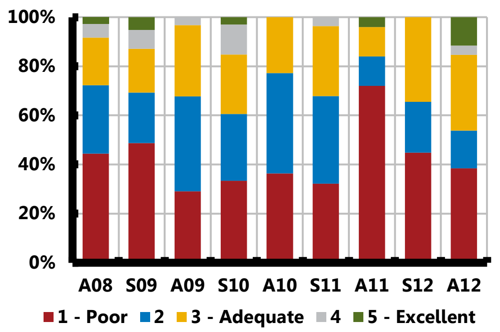


Figure 11. What is your view of liquidity with regard to government bonds over the past six months?

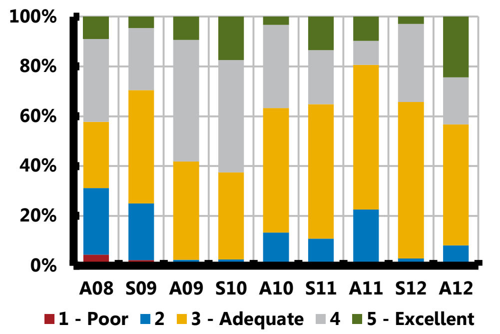


Figure 12. What is your view of liquidity with regard to mortgage certificates over the past six months?

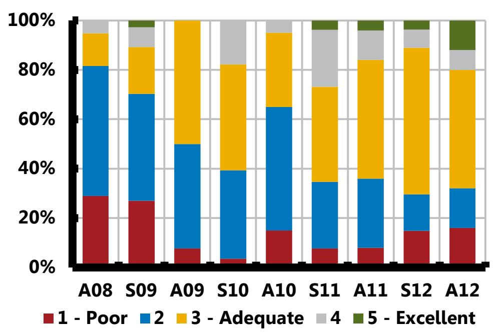
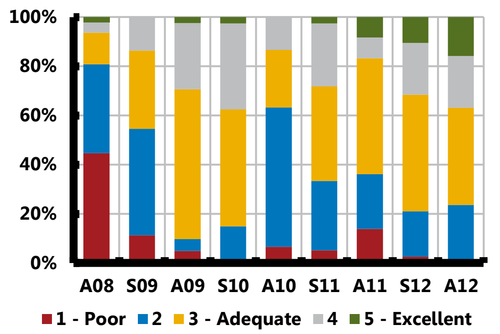


Figure 13. What is your view of liquidity with regard to mortgage bonds over the past six months?



[13] When interpreting market participants' responses in Figures 10 to 28, it is important to remember that the markets and the instruments are not necessarily comparable. This is because they often have structural differences. It is therefore more appropriate to analyse changes over time for individual instruments than to compare different instruments.

[14] Only participants active either in the Swedish fixed-income market or active in both the fixed-income market and the Krona foreign exchange market have responded to this part of the survey. The figures include only those who have been active in the specific segment.

Figure 14. What is your view of liquidity in corporate bonds over the past six months?

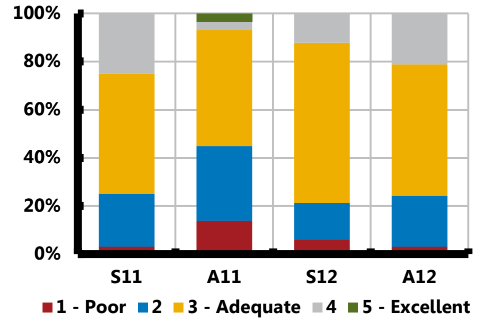


Figure 15. What is your view of liquidity with regard to fixed-income swaps (SEK/SEK) over the past six months?[15]

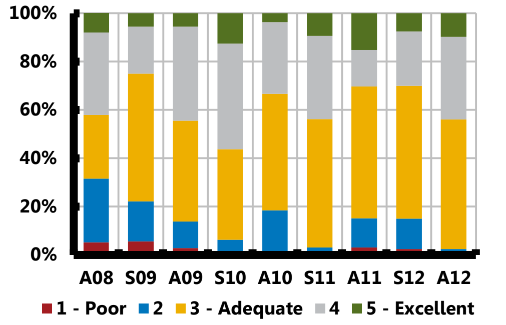


Figure 16. What is your view of liquidity in cross-currency swaps (EUR/SEK) over the past six months?[16]

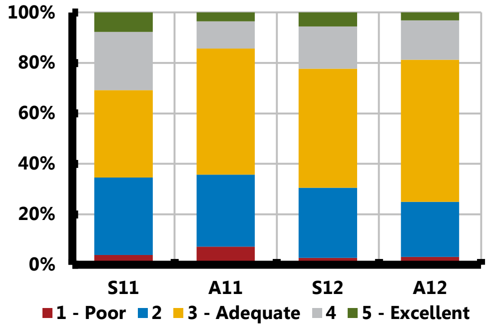


Figure 17. What is your view of liquidity in cross-currency swaps (USD/SEK) over the past six months?

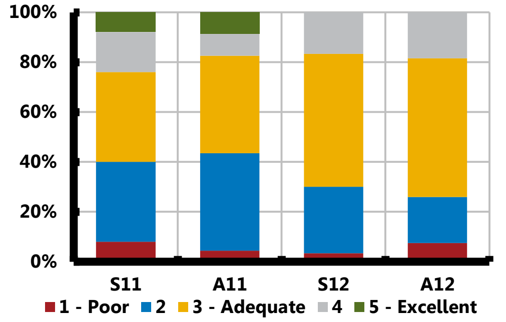


Figure 18. What is your view of liquidity in repos with government securities over the past six months?

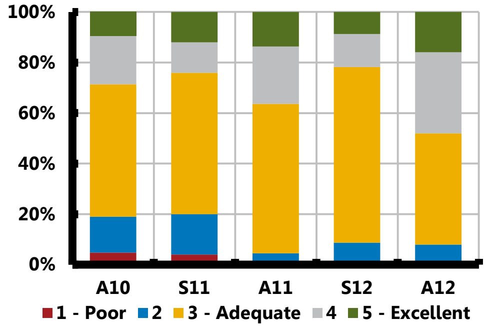
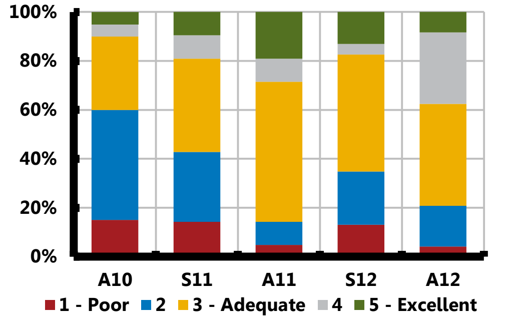


Figure 19. What is your view of liquidity in repos with mortgage securities over the past six months?



[15] A swap is an agreement between two parties to exchange a particular interest rate for another during a predetermined period of time and in accordance with certain terms.
[16] A cross-currency swap is a derivative with which an actor on the market can convert an asset or a liability to another currency than it was originally denominated.

Figure 20. What is your view on liquidity in RIBA futures over the past six months?[17]

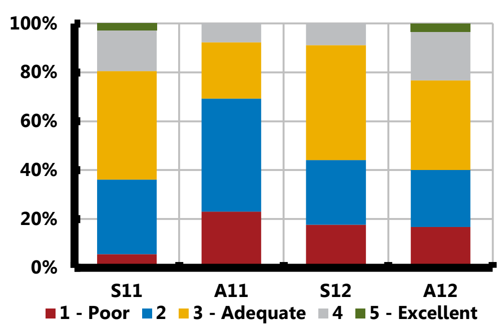


Figure 21. What is your view on liquidity in STINA swaps over the past six months?[18]

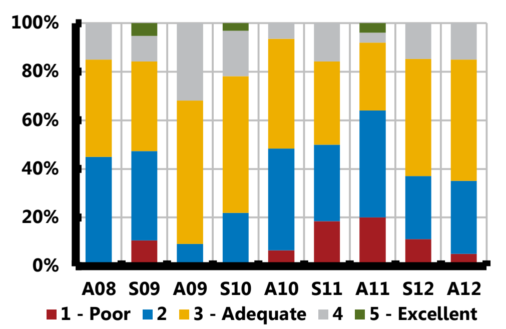
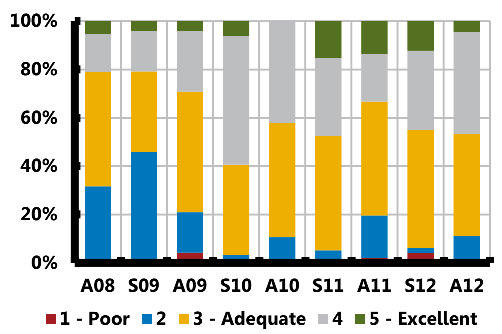


Figure 22. What is your view of liquidity with regard to FRA over the past six months?[19]



[17] RIBA futures are a standardised forward that is based on the outcome of the Riksbank's repo rate. The parties undertake to buy or sell an asset on a specified future date at a predetermined price. The contract basis is a fictitious loan, i.e. the underlying loan sums are not transferred. The maturity corresponds to the period between two IMM dates and the contract undergoes final settlement against the average repo rate for the period.

[18] STINA stands for STIBOR T/N Average. A STINA contract is an agreement lasting up to a maximum of one year to pay or receive the difference between an agreed fixed rate of interest and a variable overnight rate (STIBOR T/N).

[19] FRA stands for Forward Rate Agreement. An FRA contract is an agreement to pay or receive the difference, on a predetermined date in the future, between a predetermined interest rate and the interest rate actually applying at the date in the future.

MARKET PARTICIPANTS' ASSESSMENT OF THE LIQUIDITY OF THE INSTRUMENTS ON THE SWEDISH FOREIGN EXCHANGE MARKET[20]

Figure 23. What is your assessment of the functioning of the SEK market over the past six months?

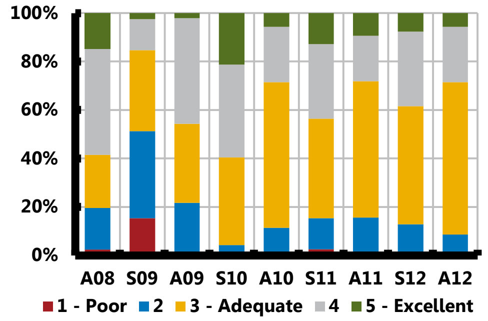


Figure 24. Compared with currencies such as the CAD, AUD and NOK, what is your assessment of the functioning of the SEK market over the past six months?

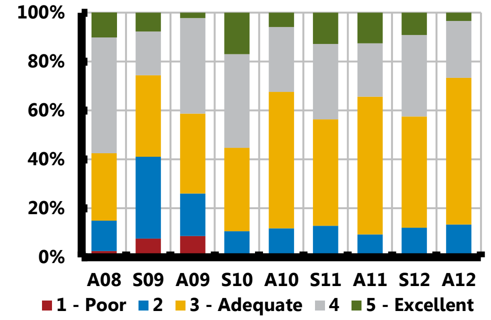


Figure 25. What is your view of liquidity with regard to the spot market over the past six months?

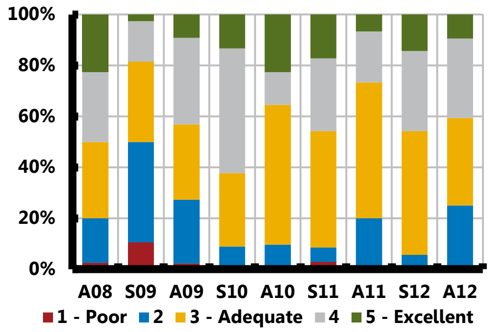


Figure 26. What is your view of liquidity regarding O/N and T/N swaps over the past six months?

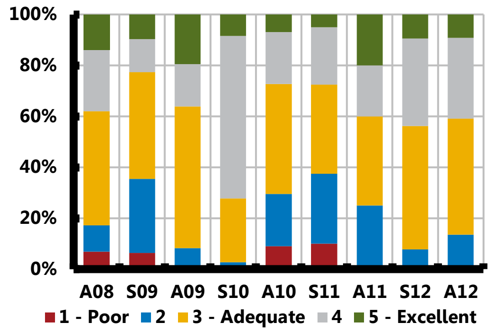


Figure 27. What is your view of liquidity with regard to futures over the past six months?

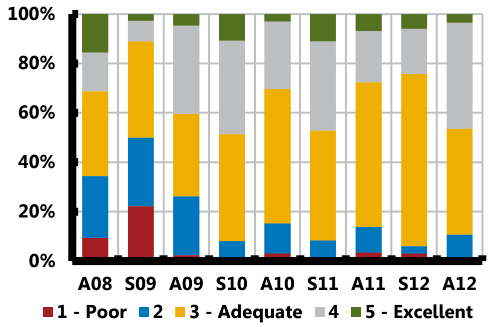
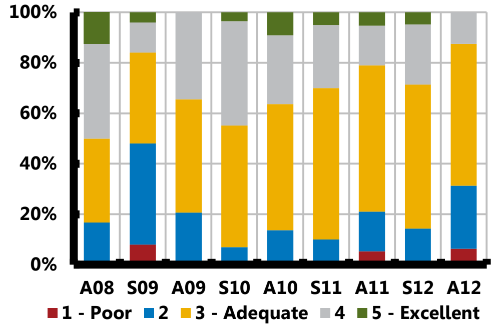


Figure 28. What is your view of liquidity with regard to currency options over the past six months?



[20] Participants active in the Swedish foreign exchange market and participants active in both the fixed-income market and the foreign exchange market responded to this part of the survey. The figures include only those who have been active in the specific segment.