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SVERIGES RIKSBANK

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

SPRING 2013

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

The Swedish financial markets are functioning well despite the continued uncertainty in the euro area, according to the market participants who responded to the Riksbank's risk survey during spring in 2013. The participants assess that liquidity has improved somewhat on both the Swedish fixed-income and foreign exchange markets. Earlier measures taken by various central banks are thought to have calmed the markets somewhat. The low interest rate environment has also meant that investors have been inclined to turn to higher-risk investments to obtain higher returns. At the same time, recent developments in Cyprus and Italy have acted as a reminder that there are still structural problems among the debt-ridden countries in the euro area. The respondents assess that developments in the euro area still comprise the main risk to the Swedish financial system. The majority of the respondents therefore believe that their propensity and possibility to take on risk will remain unchanged in the coming period. Several of them also state that they are uncertain over the effects of coming regulations.

THE SWEDISH FINANCIAL MARKETS ARE FUNCTIONING WELL DESPITE THE CONTINUING UNCERTAINTY IN THE EURO AREA

The majority of the survey respondents do not consider that there have been any major changes in the functioning of the Swedish financial markets since last autumn when the previous risk survey[2] was conducted (Figure 1). This is said to be mainly due to the continuing uncertainty in the euro area. However, one in four of the respondents do consider that the markets are functioning slightly better than last autumn. Although the differences are not very large, several of these respondents feel that the measures taken by the central banks[3] have contributed to better market functioning.

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[1] With effect from spring 2008 the Riksbank has sent out a risk questionnaire 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 market 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 27 March and 12 April 2013. The Riksbank commissioned survey company Markör Marknad och Kommunikation AB to send out 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 its regular contacts with market participants. The spring survey was sent out to 81 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 89 per cent.

[2] References to the previous, most recent or last autumn risk survey all refer to the risk survey carried out in October 2012, which covered the period April to September 2012.

[3] For instance, the ECB's decision in August 2012 on an OMT (Outright Monetary Transactions) program, the generally low policy rates internationally and continued quantitative easing through asset purchases in the United States, the United Kingdom and Japan.

According to the respondents, it is primarily market and liquidity risks that have been the driving forces behind developments in the functioning of the Swedish financial markets (Figure 2). Such market and liquidity risks are also viewed as the most difficult for their own organisation to manage.[4] In the previous risk survey the credit risks were considered to be the major driving force.[5] Many respondents say that the market risk has declined over the past six months in that there has been less volatility in prices and interest rates. This, together with an increased risk appetite among investors, has in turn contributed to liquidity being slightly higher than at the time of the previous survey.

Figure 1. What do you think of the functioning of the Swedish financial markets compared to six months ago?

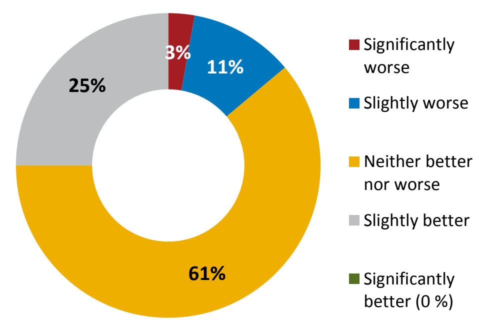
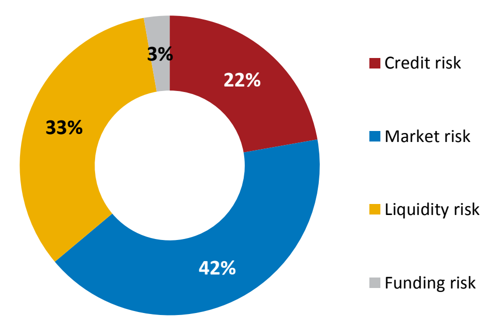


Figure 2. Which one of the following risks has been the most influential for the development in the functioning of the Swedish financial markets? [6]



The respondents are not expecting any major changes in the way the markets function during the coming six months (Figure 3). Many expect the uncertainty over developments in the debt-ridden countries in the euro area to continue. The responses to the risk survey in the spring of 2012 indicated that half of the market participants believed that market functioning would improve in the medium term, that is to say in six months to two years. One year later, in this risk survey, a majority of the respondents still state that market functioning is unchanged.

Around one third of the respondents still believe that the markets will function better in the medium term (Figure 4) and that developments in the debt-ridden countries in the euro area will improve. At the same time, almost as many respondents believe that the markets will instead function less efficiently, partly because of the uncertainty over the details regarding coming regulations. Overall, the respondents' views on developments in the medium term are thus largely unchanged since the autumn risk survey.[7]

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[4] 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 depending on how much significance they had for their organisation. See the appendix for the respondents' replies.

[5] The appendix contains the respondents' replies to the previous risk surveys. Since spring 2012, credit risk has been perceived as less of a driving force, while market risk has been perceived as more of a driving force.

[6] 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 different financial instruments and financing risk refers to their own organisation's access to liquid funds/funding.

[7] The appendix contains the respondents' earlier responses to the questions regarding market functioning in the short and medium term.

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

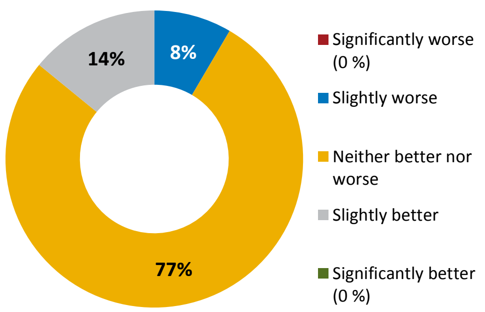
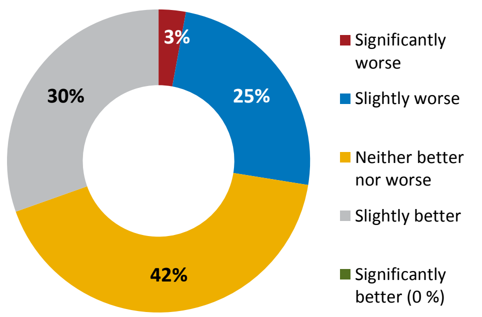


Figure 4. How do you foresee the functioning of the Swedish financial markets in the medium term (6 months to 2 years)?



DEVELOPMENTS IN THE EURO AREA STILL POSE THE LARGEST RISKS TO THE SWEDISH FINANCIAL SYSTEM

The respondents have assessed a number of risks that could have negative consequences for the Swedish financial system if realised during the coming six to twelve months. They still consider that the most probable outcome is that the various risks linked to developments in the euro area will have a negative effect on the Swedish financial markets. These are also the risks that would have the most severe consequences if they were to materialize (Table 1). On the whole, the respondents' assessment is that the risks are relatively unchanged since the previous risk survey.[8]

The sovereign debt risk in the euro area worries respondents the most. Although prospects are somewhat brighter now than in the autumn, several euro area countries are still struggling with structural problems. The probability that growth, or lack of it, and economic policy in the euro area will have a negative impact on the Swedish financial markets is also considered to be high, and the potential consequences to be severe, by the respondents. Several respondents mention that the elections in Italy have illustrated that political unrest can quickly create unease among investors. Many respondents also point to investors' reactions to the management of the bank crisis in Cyprus as an indication of prevailing fear over spill-over effects between countries.

[8] The appendix shows how the respondents consider the probabilities have changed since the previous risk survey.

Colour-coding for the scale of 1 to 8:

1	2	3	4	5	6	7	8

Very low/small **Very high/large**

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

Risk factor	Probability	Consequence
Sovereign risk in the euro area	5,9	6,0
Sovereign risk in the rest of the world	4,2	4,8
Growth related macro risks in the Baltic countries	3,4	4,4
Growth related macro risks in the euro area	5,7	5,3
Growth related macro risks globally	4,5	4,8
Risks related to economic policy in Sweden	3,1	4,8
Risks related to economic policy in the euro area	5,4	5,5
Risks related to economic policy globally	4,4	4,6
Macro risks related to large surpluses or deficits in current accounts	4,5	4,3
Swedish household debt	3,9	5,5

The respondents are still worried about the possible consequences stemming from the high level of household debt in Sweden. The negative consequences for the financial system if households were to have problems meeting their mortgage payments are assessed as substantial. However, the probability of this happening is considered to be relatively low.

The respondents assess the probability of economic developments in the Baltic countries causing problems in Sweden to be low. Nor are they worried that economic policy in Sweden will have negative consequences for the financial system.

UNCHANGED PROPENSITY TO TAKE ON RISK AMONG RESPONDENTS DUE TO PERSISTING UNCERTAINTY IN THE EURO AREA

The majority of the respondents' state that their propensity to take on risk is unchanged compared to six months ago. This is because of the remaining uncertainty over developments in the euro area. However, almost one third of the respondents say that their risk propensity has increased slightly (Figure 5). The share of respondents whose risk propensity has increased is thus greater now than at the time of the previous survey. This is partly due to the measures taken earlier by several central banks, which are still in place and are considered to have had a calming effect on the markets. Several of these respondents also say that the global low interest rate environment have led them to search for higher-risk investments to obtain higher yield. The possibilities to take on risks are also stated to remain unchanged (Figure 7). However, compared with the responses to the autumn risk survey, more respondents state that they have had increased opportunities to take on risks.

A majority of the respondents believe that both their propensity and possibility to take on risk will remain unchanged in the coming period (Figure 6 and Figure 8). Once again, it is the uncertainty in the euro area that creates a cautious approach.

Figure 5. How has your propensity to take on risk changed during the last six months?

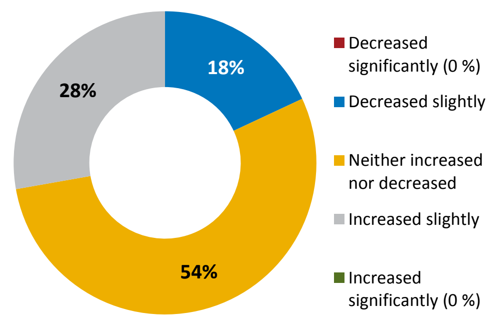


Figure 6. How do you foresee your propensity to take on risk over the coming six months?

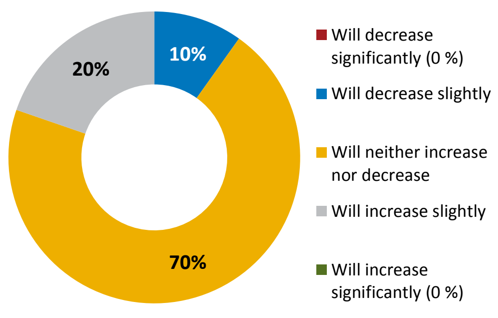


Figure 7. How have your possibilities/mandates to take on risk changed during the last six months?

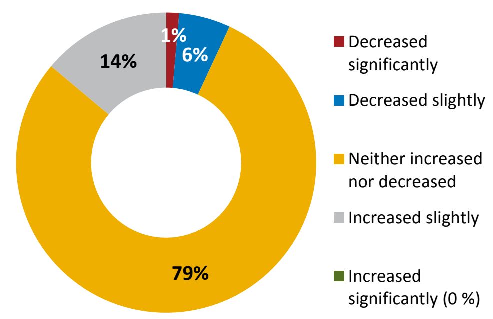
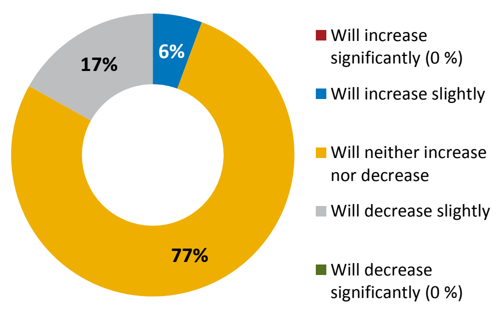


Figure 8. How do you foresee your possibilities/mandates to take on risk over the coming six months?



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. The questions cover subjects that may currently be of particular significance for the way the Swedish financial markets function.

THE RESPONDENTS EXPECT HIGHER COSTS AS A RESULT OF COMING REGULATIONS

The Riksbank asked the participants how they expect already implemented and future regulations to affect their business operations and the functioning of the financial markets. Most consider that the regulations introduced over the past six months[9], such as the Liquidity Coverage Ratio (LCR) for Swedish banks, have not affected the functioning of the markets to any greater extent.

Several respondents state that coming regulations for the banks through Basel III[10] and for derivatives on the OTC market[11] through EMIR[12] will affect the functioning of the markets. For instance, they believe that the increased reporting requirements in both EMIR and Basel III will lead to increased administrative costs. They also believe that the requirement for central counterparty clearing when trading derivatives contracts, which is included in EMIR, will make it more expensive to trade derivatives. The respondents are also assuming that the banks will pass on large parts of these costs to their customers, leading to reduced liquidity in the markets.

Some of the respondents who believe that derivatives trading will become more expensive consequently expect a decrease in the use of derivatives to manage financial risks. On the contrary, other respondents believe that EMIR will cause liquidity to increase, by lowering the counterparty risk which should induce increased risk propensity among investors.

THE LOW INTEREST RATES INCREASE INVESTORS' DEMAND FOR HIGHER-RISK ASSETS

Many respondents feel that the low interest-rate environment has led to investors seeking higher-risk investments to obtain higher returns, resulting in an increase of both the supply and demand for corporate bonds. The respondents also point to the general low interest rate environment, coupled with decreased risks, as the reason to why the interest rate deviation between different instruments[13] has decreased on the Swedish fixed-income market. A few respondents cautioned that continued low interest rates may lead to the buildup of imbalances as well as increased household indebtedness.

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[9] Examples of regulations implemented include the LCR for Swedish banks and the short selling regulation. The LCR is a measure of liquidity included in the Basel III Accord (see below). The LCR makes requirements of a bank's ability to manage a stressed net outflow of liquidity during 30 days and was implemented on 1 January 2013. The EU short selling regulation (the Regulation on short selling and certain aspects of credit default swaps) was introduced in November 2012. It entails the introduction of limits on certain short positions in equity and government bonds, as well as restrictions on certain holdings of credit default swaps (CDS) in government securities.

[10] Basel III is an international regulatory framework for banks that mainly regulates capital adequacy, that is, how much capital a bank must hold in relation to the risk it takes, and liquidity management. The Basel III Accord will be progressively phased in by 2019. See also the article on Basel III in Financial Stability Report 2010:2, Sveriges Riksbank.

[11] OTC stands for “over the counter” and refers to trade between two parties that is not conducted on a central marketplace.

[12] EMIR is an EU regulation that covers the management of counterparty risks in OTC derivatives transactions and requirements for reporting derivatives transactions. It also regulates central counterparties and trade repositories in the EU. See also the Economic Commentary The derivative market is facing major changes, 10 December 2012.

[13] For instance the difference has declined between the three-month interbank rate and the average expected policy rate for the same maturity. There has also been a decline in the difference between five-year mortgage bonds and a fixed-income swap with the same maturity.

The survey respondents state that if global interest rates were to rise earlier and to a greater extent than anticipated, for instance if central banks were to withdraw ongoing stimulus measures, it would not necessarily lead to unease on the Swedish financial markets. Several respondents reason that higher interest rates in themselves are not a problem, unless interest rates in Sweden and abroad start diverging. If interest rates abroad were to rise above Swedish interest rates, foreign investors would become less inclined to hold Swedish assets. This could lead to a situation where many investors want to sell their assets at the same time and thereby cause major market fluctuations. Several respondents also believe that this would weaken the Swedish krona.

THE RESPONDENTS ARE GENERALLY POSITIVE TO THE SWEDISH BANKERS' ASSOCIATION'S FRAMEWORK FOR STIBOR

Many respondents believe that the Swedish Bankers' Association's new framework for Stibor[14] will lead to greater confidence in the reference rate and how it is set. At the same time, most respondents say that the new framework does not entail any major differences for the reference rate. The new framework means that Stibor is now set for maturities of up to six months. A couple of respondents state that they would like to see a reference rate with maturities up to one year, as before.

ELECTRONIC TRADING CONTRIBUTES TO GREATER LIQUIDITY

The majority of the respondents are positive to how the increased element of electronic trading via trading platforms has impacted the foreign exchange market. Most of them say that the difference between buying and selling prices has declined, thereby lowering volatility. Many also say that it has led to greater transparency and on the whole contributed to increased liquidity. At the same time, a couple of respondents emphasise that this only applies to days without major market-altering news and that electronic trading actually tends to reinforce market reactions when major events occur.

[14] 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. See the Riksbank's inquiry into Stibor from 2012 for more information.

Liquidity in the Swedish fixed-income and foreign exchange markets[15]

To obtain an idea of how the various sub-markets have functioned over the past six months, the risk survey contains a number of questions about liquidity for specific instruments.[16]

GENERALLY ADEQUATE LIQUIDIY ON THE SWEDISH FIXED-INCOME AND FOREIGN EXCHANGE MARKETS

The liquidity in the instruments on the Swedish fixed-income and foreign exchange markets has improved somewhat since the previous risk survey. However, the changes are marginal. Liquidity is generally assessed to be adequate or better.

MARKET PARTICIPANTS' ASSESSMENT OF THE LIQUIDITY IN INSTRUMENTS ON THE SWEDISH FIXED-INCOME MARKET[17]

Figure 9. What is your view of liquidity with regard to treasury bills over the past six months?

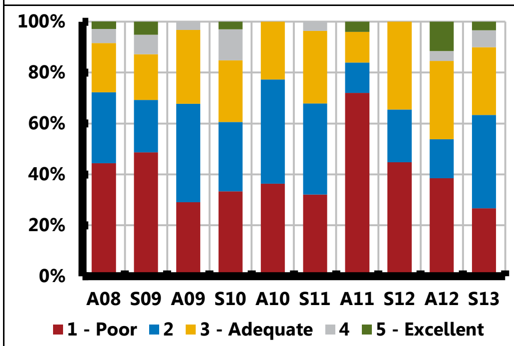


Figure 10. What is your view of liquidity with regard to government bonds over the past six months?

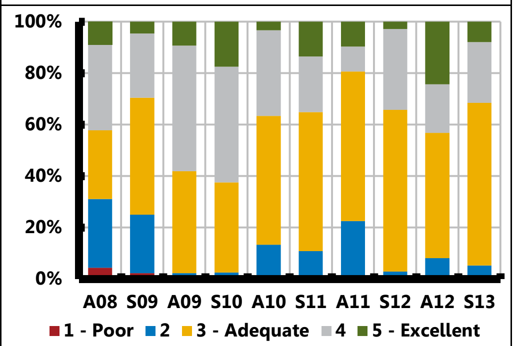


Figure 11. What is your view of liquidity with regard to mortgage certificates over the past six months?

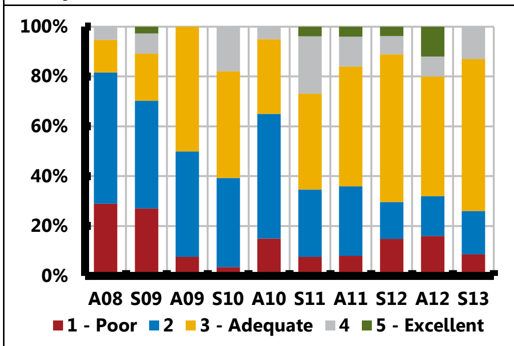
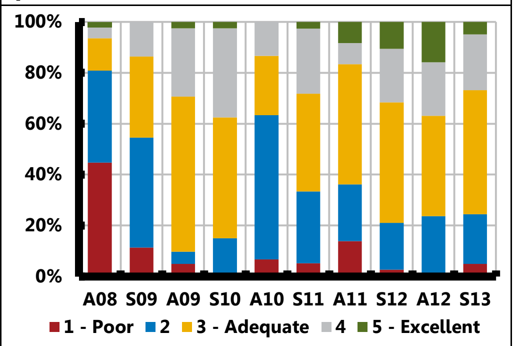


Figure 12. What is your view of liquidity with regard to mortgage bonds over the past six months?



[15] When interpreting market participants' responses in Figures 9 to 27, it is important to remember that the markets and the instruments are not necessarily comparable since they often have structural differences. It is therefore more appropriate to analyse changes over time for individual instruments than to compare different instruments.
[16] Survey respondents were asked to rate how liquidity had been for the specific instrument on the basis of how easy it has been to sell large volumes and how large the difference between buying and selling prices has been. They were asked to rate on a scale of 1 to 5, where 1 is poor and 5 is excellent.
[17] Only participants active either in the Swedish fixed-income market or active in both the fixed-income market and the 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 13. What is your view of liquidity regarding corporate bonds over the past six months?

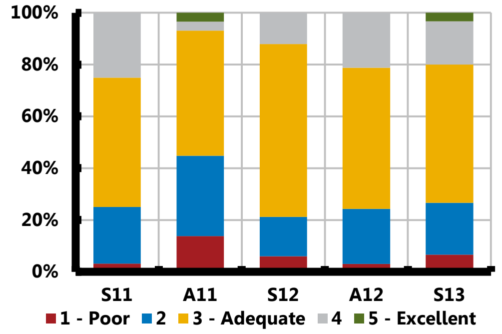


Figure 14. What is your view of liquidity with regard to fixed-income swaps (SEK/SEK) over the past six months?[18]

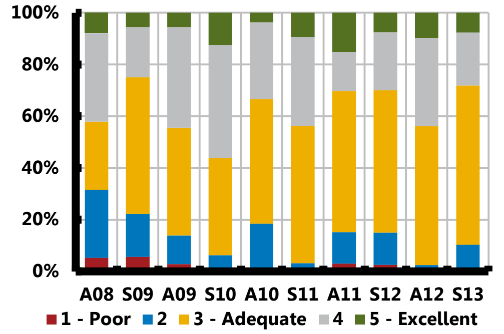


Figure 15. What is your view of liquidity in cross-currency swaps (EUR/SEK) over the past six months?[19]

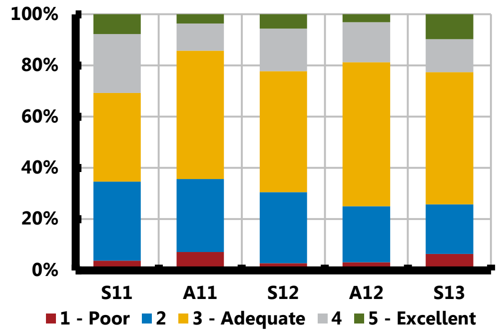


Figure 16. What is your view of liquidity in cross-currency swaps (USD/SEK) over the past six months?

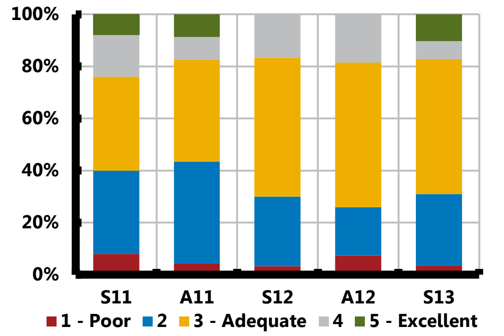


Figure 17. What is your view of liquidity in repos with government securities over the past six months?

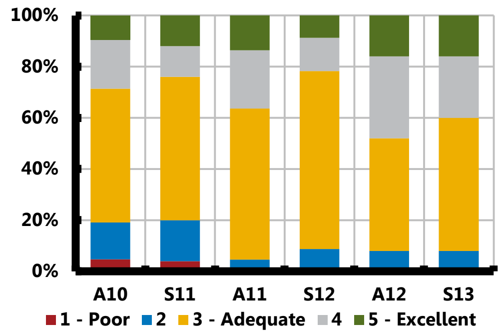
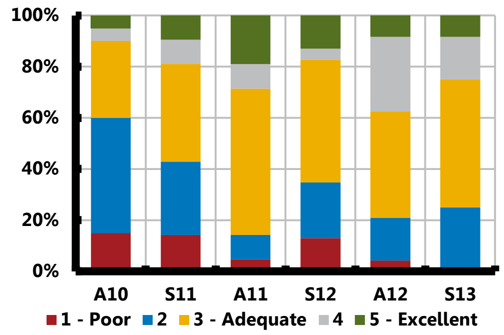


Figure 18. What is your view of liquidity in repos with mortgage securities over the past six months?



[18] A fixed-income swap is a bilateral agreement to exchange a specific interest rate in return for another interest rate for a predetermined period according to specific conditions.

[19] A cross-currency swap is a bilateral agreement to exchange a specific currency in return for another currency for a predetermined period according to specific conditions.

Figure 19. What is your view of liquidity with regard to RIBA futures over the past six months?[20]

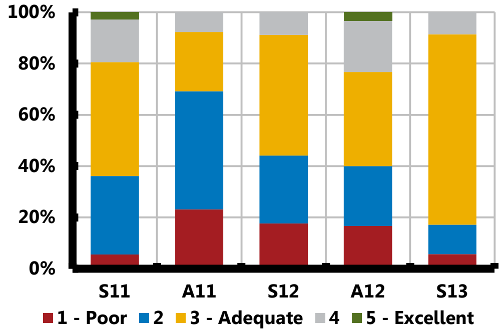


Figure 20. What is your view of liquidity with regard to STINA swaps over the past six months?[21]

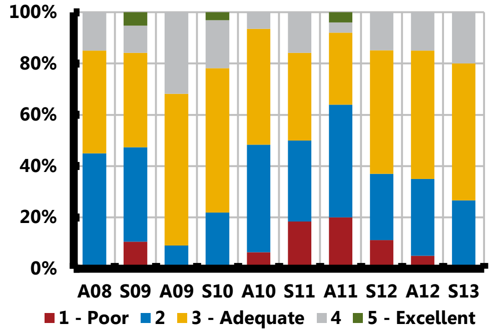
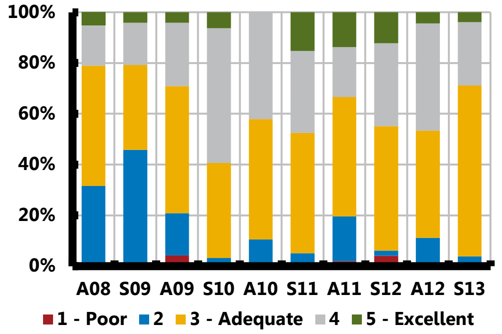


Figure 21. What is your view of liquidity with regard to FRA over the past six months?[22]



[20] RIBA futures are a standardised forward that is based on the outcome of the Riksbank's repo rate. 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 in question.
[21] 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).
[22] 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 [23]

Figure 22. What is your assessment of the functioning of the SEK market over the past six months?

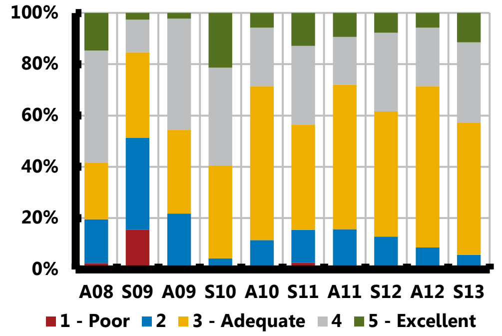


Figure 23. Compared with currencies such as the CAD, AUD and NOK, what is your assessment of the functioning of the SEK market over the past six months?

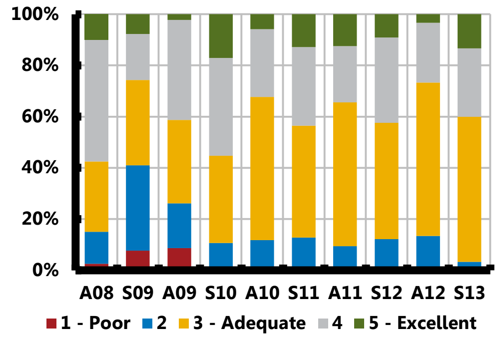


Figure 24. What is your view of liquidity with regard to spot transactions over the past six months?

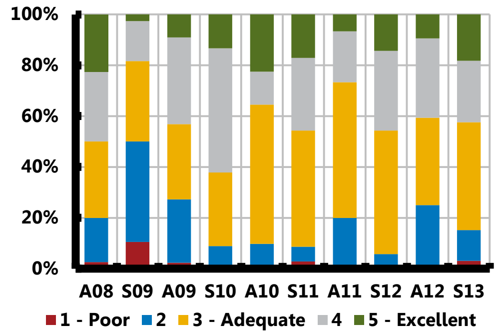


Figure 25. What is your view of liquidity regarding O/N and T/N swaps over the past six months?

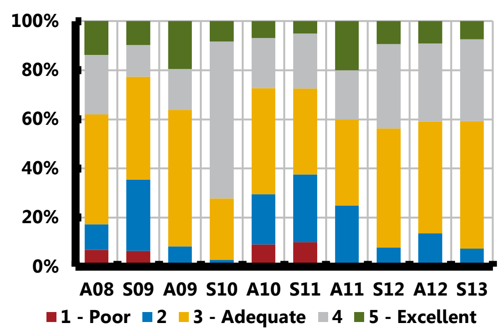


Figure 26. What is your view of liquidity with regard to forward transactions over the past six months?

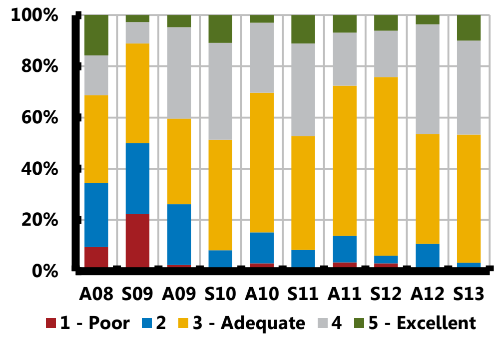
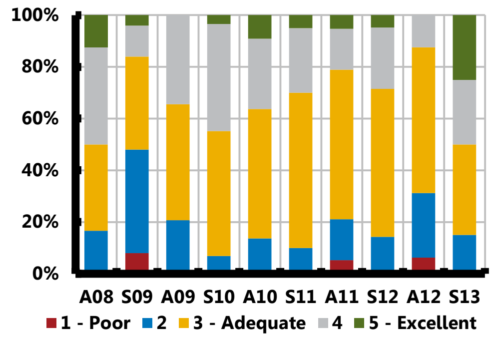


Figure 27. What is your view of liquidity with regard to foreign exchange options over the past six months?



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

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Appendix – Distribution of responses over time and in greater depth

Below is a compilation of the respondents' replies over time to a number of questions regarding market functioning and their risk propensity. The appendix also contains a further in-depth description of how respondents assess that the risks to the Swedish financial system have changed since the previous risk survey and what risks would be most difficult for their organisation to manage.

Figure 28. What is your assessment of the functioning of the financial markets compared with six months ago?

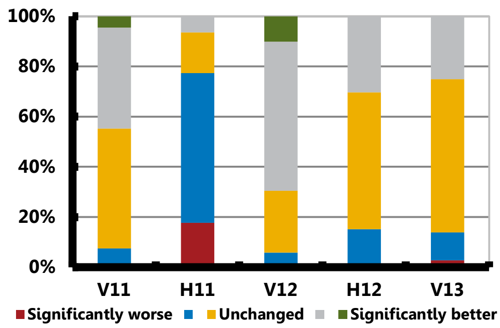

Figure 29. What are your views on the functioning of the market in the short run (6 months)?

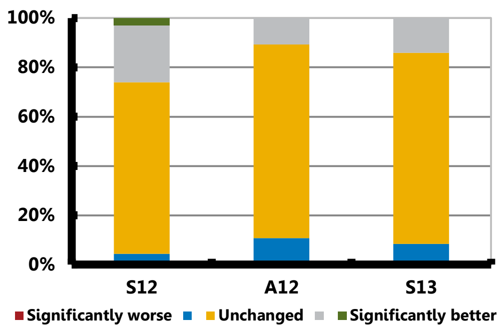

Figure 30. What are your views on the functioning of the market in the medium run (6 months to 2 years)?

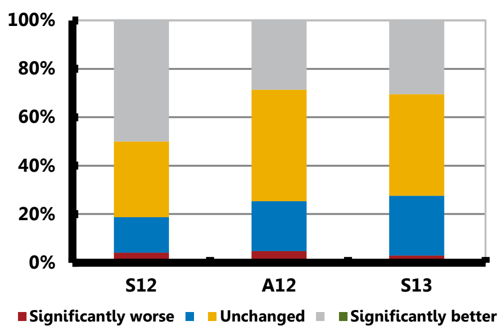

Figure 31. How has your propensity to take risks changed compared to six months ago?

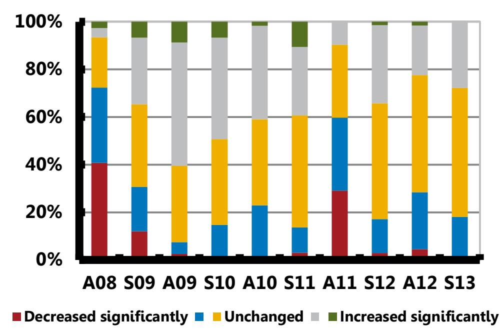

Figure 32. How do you foresee your propensity to take risk over the coming six months?

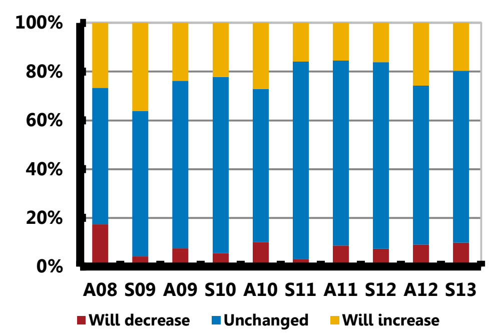

Figure 33. Which of the following risks has been the biggest driving force behind developments in the functioning of the Swedish market?

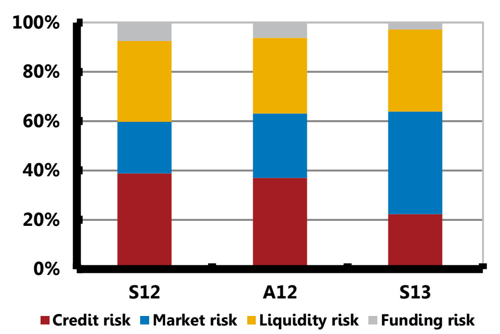

Figure 34. The respondents' assessment of the probability of the selected risk factors in Table 1 has changed since the previous risk survey

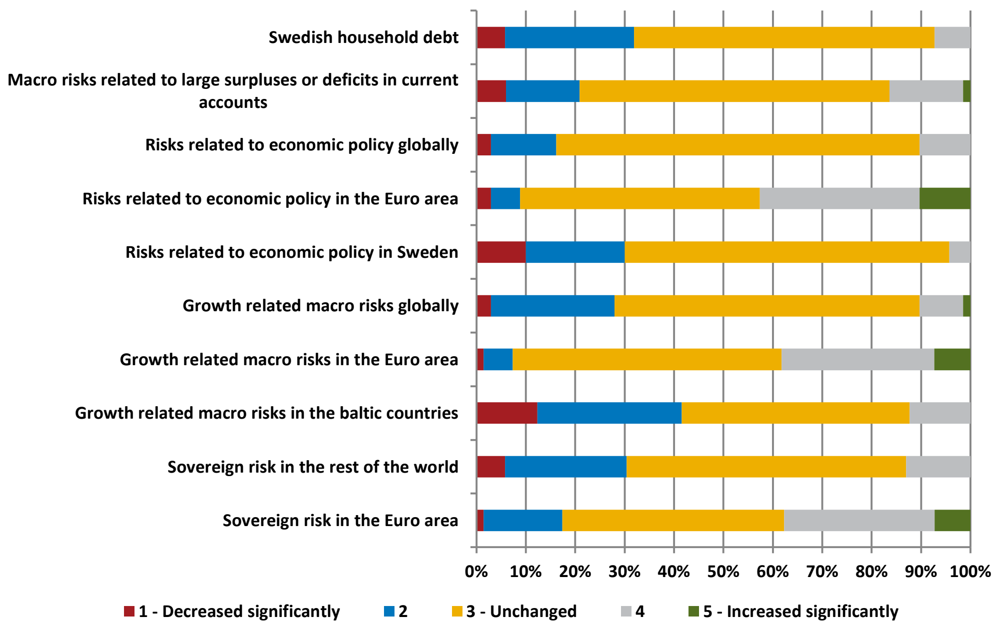

Figure 35. The respondents' assessment of which risks would be most difficult for their organisations to manage if they increase, percentage of responses