

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

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■ Market participants' views on risks and the functioning of the Swedish fixed-income and foreign exchange markets¹

The Swedish financial markets are functioning well according to the market participants who responded to the Riksbank's risk survey in spring 2014. The respondents consider that the overall risk level in the Swedish financial system is relatively unchanged compared with six months ago, but that the risks at a global level have changed somewhat. On the whole, the respondents assess that risks linked to emerging markets have increased, at the same time as they consider that the risks linked to developments in the euro area have declined.

More respondents than before have had an increased propensity to take risk during the past six months and many believe their propensity will increase further in the coming period. In particular respondents on the fixed-income market state the reason for this as the increasing demands to generate a return. They also point out that many investors are seeking more risky investments, such as corporate bonds, in the search for yield. Some respondents claim that the secondary market for corporate bonds is less liquid than other bond markets, and that this could possibly create price volatility and uncertainty in a situation where many investors want to sell their holdings at the same time.

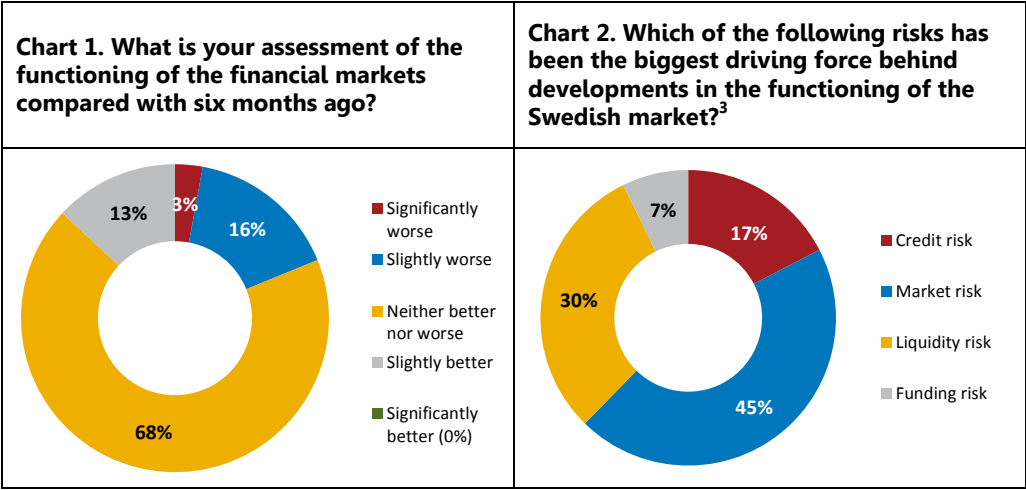
SWEDISH FINANCIAL MARKETS ARE FUNCTIONING WELL BUT RISKS AT THE GLOBAL LEVEL HAVE CHANGED SOMEWHAT

The majority of the respondents do not consider there have been any major changes in the functioning of the Swedish financial markets since the previous² risk survey was carried out in autumn 2013 (see Chart 1). The respondents active on the fixed-income market are in general less positive about the functioning of the Swedish market than those who are active on the foreign exchange market. Several respondents on the fixed-income market state that the market makers' reduced propensity to take risk has made the financial system more vulnerable.

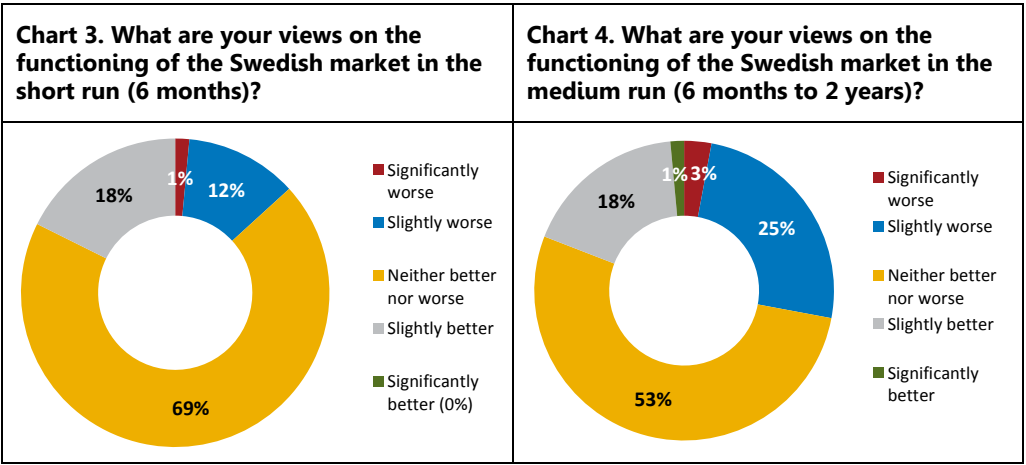
Over the past six months, the respondents say that liquidity risk and, above all, market risk have been the driving forces behind developments on the Swedish financial markets (see Chart 2). This is in line with the respondents' answers in the previous risk survey. Participants in the foreign exchange market appear to perceive to a greater extent than participants in the fixed-income market that market risk has increased over the past six months. They state that this is due to lower liquidity, which results in higher price volatility. Most of the participants who responded to the risk survey consider, however, that risks on the whole have remained unchanged over the past six months (see Chart 36).

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 gain an overall picture of the view of risk and the functioning of the Swedish financial 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 6 March and 17 March 2014. 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 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 88 per cent.

² References to the previous or last autumn's risk survey all refer to the risk survey carried out in October and November, which covered the period April to November 2013.



The respondents are not on the whole expecting any major changes in the market functioning in the coming period, neither in the short run (see Chart 3) nor in the longer run (see Chart 4). However, the percentage of participants who believe in an improvement in functioning in the short term has increased since the previous survey (see Chart 31). In the longer run, the view is unchanged and one quarter of the participants, primarily those who are active on the foreign exchange market, still believe that the Swedish market will function somewhat less efficiently in six months to two years (see Chart 32). These participants believe that the coming implementation of the remaining parts of the regulation on trading in derivative contracts outside of regulated market places, EMIR, will have a negative effect on the functioning of the Swedish market.



MARKET PARTICIPANTS ARE WORRIED TO AN INCREASING EXTENT OVER RISKS RELATED TO EMERGING MARKETS

The respondents have assessed a number of pre-defined risks that could have negative consequences for the Swedish financial system if realised during the coming six to twelve months (see Table 1). They consider that the probability of risks linked to emerging markets being realised has increased (see Chart 37). Several respondents mention, for instance, that the risk that the Chinese economy, like other emerging markets, will provide a smaller contribution to global growth has increased. Although the probability of such a development has increased, participants

³ Credit risk refers to the risk that counterparties and issuers will be unable to meet their commitments, while market risk refers to volatility in prices and interest rates, liquidity risk refers to depth and price picture for different financial instruments and financing risk refers to their own organisation's access to liquid funds/funding.

consider that the potential consequences for the Swedish financial system would be relatively limited.

The risks linked to developments in the euro area are still regarded as significant, although the probability that they will be realised is thought to have declined somewhat over the past six months. This applies to the risks linked to economic growth, or lack of it, to economic policy and to developments in public finances in the euro area (see Chart 37). Moreover, the respondents assess that potential consequences for the Swedish financial system have declined somewhat. Several respondents consider that the concern over the countries with debt problems in the euro area has declined as economic prospects have improved.

The respondents take a serious view of the potential consequences that could ensue if the risks linked to the high household indebtedness in Sweden were realised. The negative consequences for the Swedish financial system from risks that are related to the Swedish households' indebtedness are still considered to be extensive, although they remain unchanged compared with six months ago. The probability of such risks being realised is assessed by the respondents to be unchanged since the previous risk survey (see Chart 37).

Colour-coding for the scale of 1 to 8:

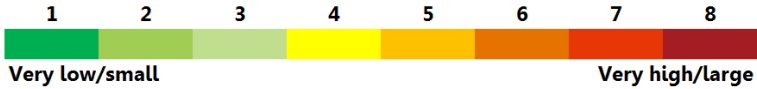


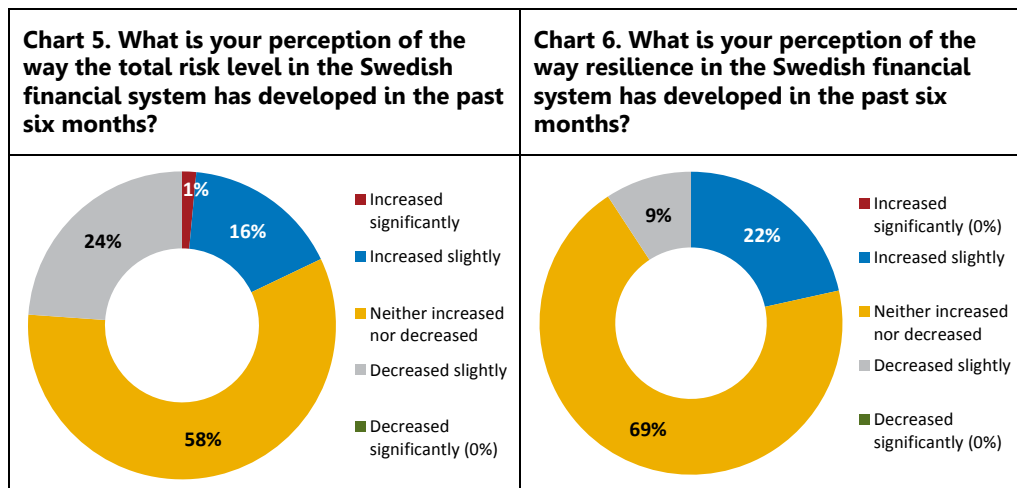
Table 1. The participants' assessment of selected risks that can affect the Swedish financial system

Risk factor	Probability	Consequence
Worsening of fiscal unease in the euro area	4.2	5.2
Growth-related macro risks in the euro area	4.7	5.1
Growth related macro risks globally	4.9	5.1
Risks related to economic policy ¹ in Sweden	3.7	5.5
Risks related to economic policy ¹ in the euro area	4.6	5.0
Risks related to economic policy ¹ in the United States	4.3	4.8
Risks related to emerging markets	5.8	4.9
Risks related to capital flows	4.9	5.1
Risks related to household indebtedness in Sweden	4.2	5.7

¹ Economic policy refers to both monetary and fiscal policy.

UNCHANGED LEVEL OF RISK AND RESILIENCE IN THE SWEDISH FINANCIAL SYSTEM

Table 1 above shows how the respondents assess individual risks that could have negative consequences for the Swedish financial system if they were realised. The respondents have also given their views of the overall risk level and resilience of the system. Most of them consider that both the level of risk and resilience have remained unchanged over the past six months (see Charts 5 and 6). The respondents who consider that the total risk level in the system has increased somewhat, most of whom are investors, explain this by saying that many investors seek more risky investments, such as corporate bonds, to attain a higher return than, for instance, on government bonds. The respondents consider that this has contributed to a higher level of risk taking, which also corresponds to a larger number of respondents considering they have had an increased propensity to take risk during the period (see below).



THE RESPONDENTS' PROPENSITY TO TAKE RISK HAS INCREASED SOMEWHAT AND IS EXPECTED TO CONTINUE TO RISE

Just under half of the respondents state that their propensity to take risk is unchanged compared to six months ago (see Chart 7). At the same time, one in four considers that their own propensity to take risk has increased since the previous risk survey. Participants in the foreign exchange market explain this by saying that the prospects for global growth have improved, while those who are active on the fixed-income market state that it is due to higher requirements for generating return. A larger percentage of market makers than other respondents state that their propensity to take risk has declined during the period.

Most of the respondents believe that their propensity to take risk (see Chart 8) and their possibility to do so will remain unchanged during the coming six months (see Chart 10). Compared with the previous risk survey, however, there are more respondents than before who believe that their propensity to take risk will increase somewhat (see Chart 34). The respondents explain this by higher requirements to generate return and that they see more investment opportunities now than before.

Chart 7. How has your propensity to take risks changed compared to six months ago?

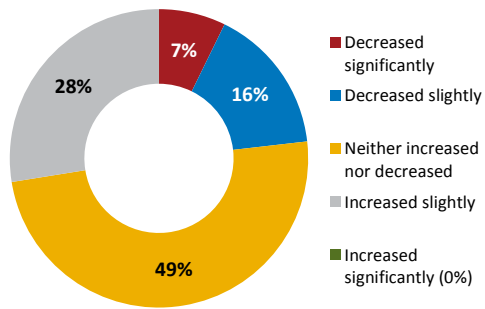


Chart 8. How do you foresee your propensity to take risk over the coming six months?

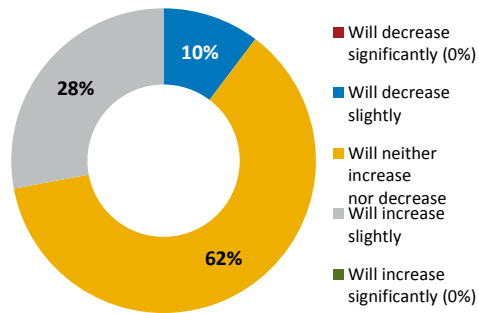


Chart 9. How has your scope/mandate to take risk changed compared to six months ago?

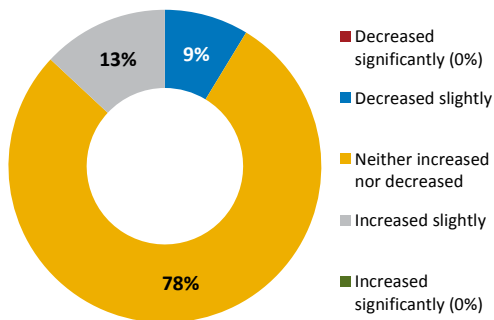
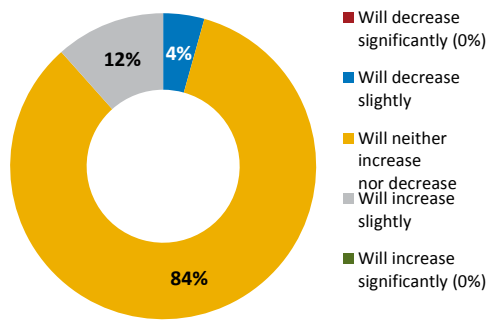


Chart 10. How do you foresee your scope/mandate to take risk over the coming six months?



Open-ended questions related to the functioning of the fixed-income and foreign exchange markets⁴

The Riksbank also posed a number of open-ended questions to the market participants. The questions cover subjects that have been topical during the period the risk survey was carried out and may have particular significance for the way the Swedish financial markets function.

RESPONDENTS PREDICT POORER LIQUIDITY ON DERIVATIVES MARKET AS A RESULT OF REGULATION

Several respondents consider that the regulation of derivatives trading on the OTC market⁵ through EMIR⁶ will have a negative effect on the functioning of the Swedish financial markets.⁷ The respondents have expressed similar opinions in the previous three risk surveys. They consider that the reporting requirements implemented through EMIR have led to increased administrative costs. Several respondents also believe that the requirement for central counterparty clearing when trading derivatives contracts, which is included in EMIR, will make this form of trading more expensive. The respondents assume that these increased costs will to a large degree be passed on to customers who will therefore use derivative contracts to a lesser extent than before. The respondents thus believe that market liquidity will decline in line with the higher costs, as a result of this.

Several market makers also mention that the US regulation on financial markets, the Dodd-Frank Act⁸, indirectly affects the Swedish financial markets. This is because many foreign investors can no longer be active on the Swedish derivative market in the same way.

SWEDISH MARKET MAKERS' PROPENSITY TO TAKE RISK CONTINUES TO DECLINE, ACCORDING TO RESPONDENTS

As in the previous risk survey, many respondents feel that the Swedish market makers' propensity to take risk has continued to decline over the past six months. This assessment is made by both market makers themselves and by investors in the fixed-income market. The respondents perceive that the market makers in the fixed-income market do not wish to hold such large stocks of assets as before, which they believe is due to the expected future capital adequacy requirements. According to the respondents, the market makers thus become less willing than before to offer prices, which they consider has made it both more difficult and more expensive to execute transactions.

Several respondents describe the market makers on the Swedish fixed-income market as being divided into two groups. One group consists of foreign market makers who try to reduce their activities by offering less competitive prices. The other group consists of Swedish market makers who try to increase their activities by offering more attractive prices. The respondents consider there are thus fewer market makers than before that are offering acceptable liquidity. Something that they in turn consider has made the financial system more vulnerable.

⁴ Appendix 2 contains a compilation of the open questions the Riksbank put to respondents.

⁵ OTC stands for "over the counter" and refers to trade between two parties that is not conducted on a regulated or organised marketplace.

⁶ 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 Eklund, J, Sandström, M and Stenkula von Rosen, J, The derivative market is facing major changes, Economic Commentary No. 6 2012, Sveriges Riksbank.

⁷ Not all parts of EMIR have been fully implemented yet. For example, the requirements for detailed transaction reporting to the transaction register have already been implemented, while the requirement for central counterparty clearing will be implemented further ahead.

⁸ The Dodd-Frank Wall Street Reform and Consumer Protection Act is a compendium of financial regulations aimed at protecting consumers and stabilising the financial system in the United States.

CONTINUING LARGE DEMAND FOR CORPORATE BONDS FROM SWEDISH INVESTORS

According to the respondents, interest in corporate bonds has continued to increase among issuers and investors over the past six months. In line with earlier risk surveys, many respondents say that the low interest rates that have characterised the markets for some time have led to investors seeking more risky investments, such as corporate bonds, as these can often give a higher return than, for instance, government bonds. However, despite interest in issuing bonds having increased among companies, several respondents consider that the supply of corporate bonds is small, given the existing demand, which they think is due to companies having a limited borrowing requirement.

A number of respondents perceive that the market for corporate bonds largely consists of trading in the primary market and that the secondary market, where holdings can be bought and sold, is less liquid than other bond markets. They feel that this could create price volatility and uncertainty in a situation where many investors want to sell their holdings at the same time.⁹

A SMALL NUMBER OF RESPONDENTS PERCEIVE THE VARYING INTEREST IN INVESTING IN RIKSBANK CERTIFICATES AS A PROBLEM

For the past year or so, interest in investing in the Riksbank's weekly certificates has varied. As liquidity in the banking system varies, depending on investment in certificates, a small number of market makers consider this to have made it more difficult for them to estimate future liquidity in Swedish krona. According to the market makers, Swedish short-term interest rates have therefore fluctuated on several occasions, to a greater degree than before. However, the investors who responded to this question did not perceive that this problem had affected them to any great extent.

⁹ For further information on how the corporate bond market works, see Gunnarsdotter, G and Lindh, S, Markets for Swedish non-financial corporations' loan-based financing, Economic Review 2011:2, Sveriges Riksbank.

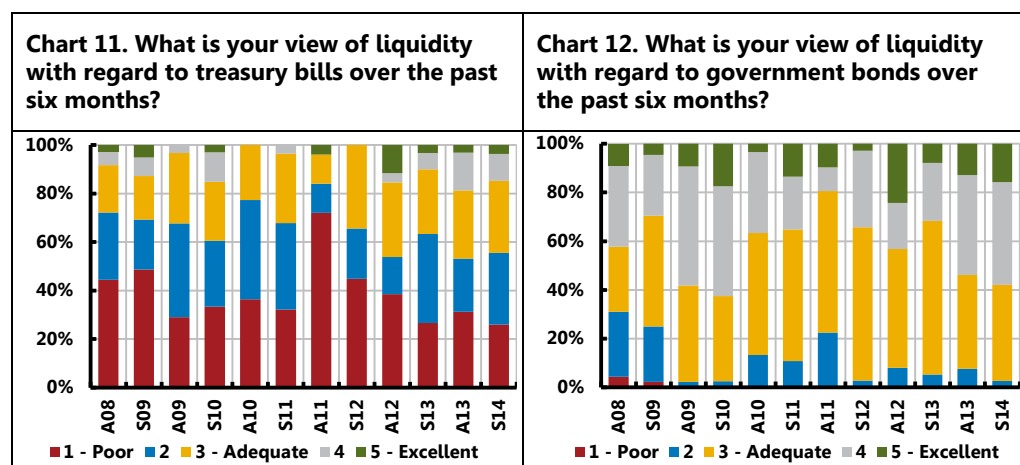
Liquidity in the Swedish money and bond and foreign exchange markets¹⁰

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.¹¹

MARGINALLY BETTER LIQUIDITY ON THE SWEDISH FIXED-INCOME AND FOREIGN EXCHANGE MARKETS

In line with the previous risk survey, the liquidity in the various instruments on the Swedish fixed-income and foreign-exchange markets is generally considered to be adequate or better. Liquidity is said to have improved somewhat for most of the instruments, but these are only marginal changes. In contrast to this are the instruments RIBA future (Chart 21) and STINA swaps (Chart 22), where more respondents than before consider liquidity to be poor. Both instruments are closely linked to the way the short-term Swedish fixed-income market functions and as mentioned before, a number of respondents perceive this market to have functioned somewhat less efficiently during the period (see page 8).

MARKET PARTICIPANTS' ASSESSMENT OF THE LIQUIDITY IN INSTRUMENTS ON THE SWEDISH FIXED-INCOME MARKET¹²



¹⁰ When interpreting market participants' responses in Figures 11 to 29 below, 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.

¹¹ 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.

¹² 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.

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

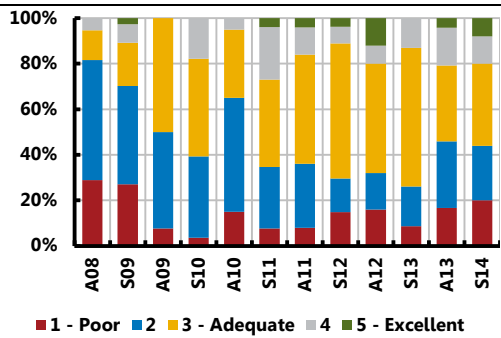


Chart 14. What is your view of liquidity with regard to mortgage bonds over the past six months?

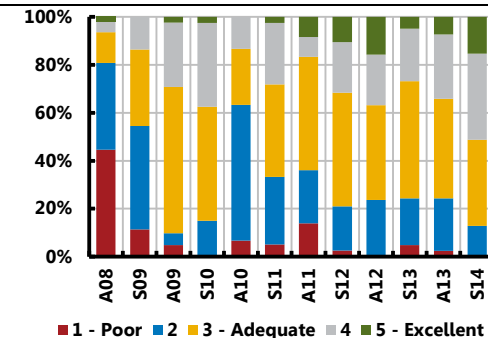


Chart 15. What is your view of liquidity regarding corporate bonds over the past six months?

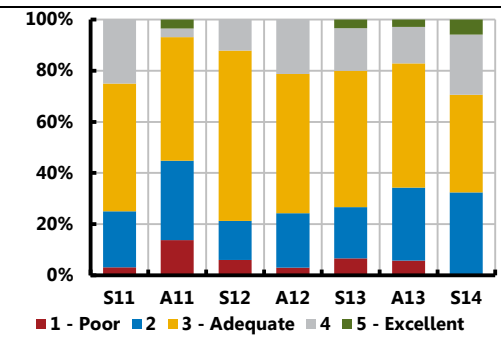


Chart 16. What is your view of liquidity with regard to fixed-income swaps (SEK/SEK) over the past six months?¹³

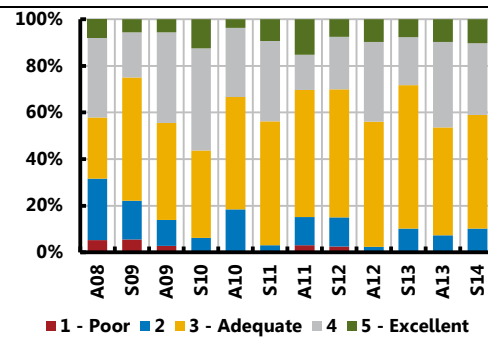


Chart 17. What is your view of liquidity in cross-currency swaps (EUR/SEK) over the past six months?¹⁴

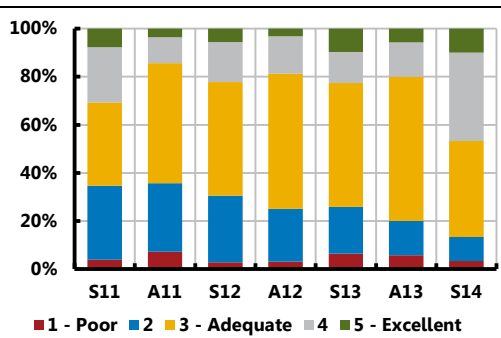
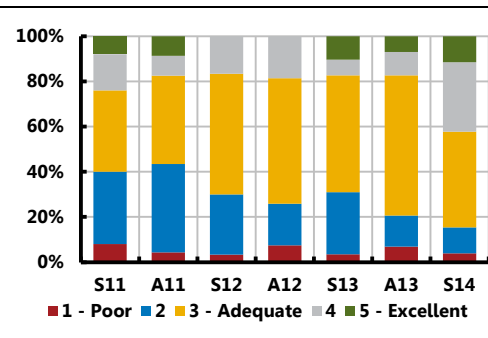


Chart 18. What is your view of liquidity in cross-currency swaps (USD/SEK) over the past six months?



¹³ 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.

¹⁴ 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.

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

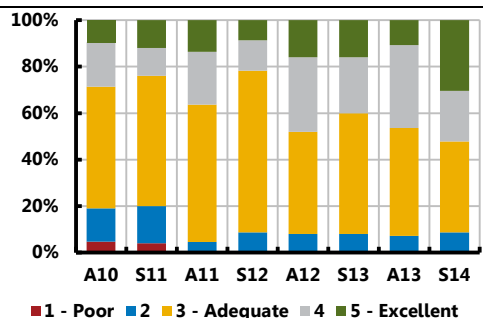


Chart 20. What is your view of liquidity in repos with mortgage securities over the past six months?

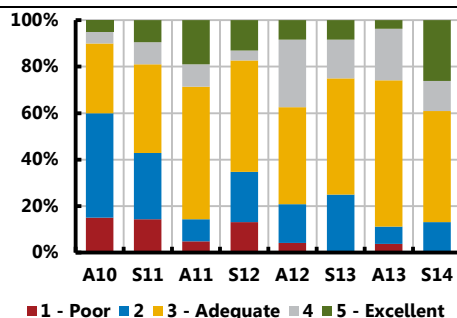


Chart 21. What is your view of liquidity with regard to RIBA futures over the past six months?¹⁵

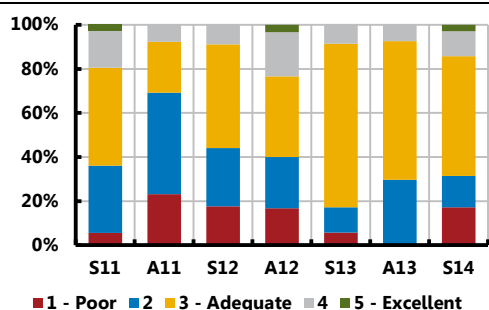


Chart 22. What is your view of liquidity with regard to STINA swaps over the past six months?¹⁶

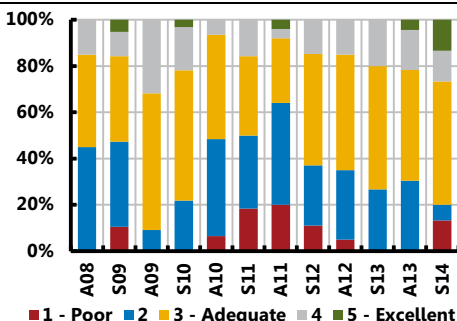
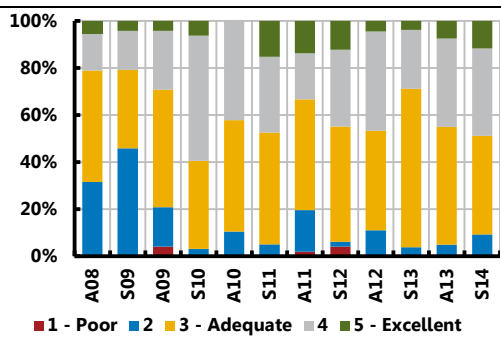


Chart 23. What is your view of liquidity with regard to FRA over the past six months?¹⁷

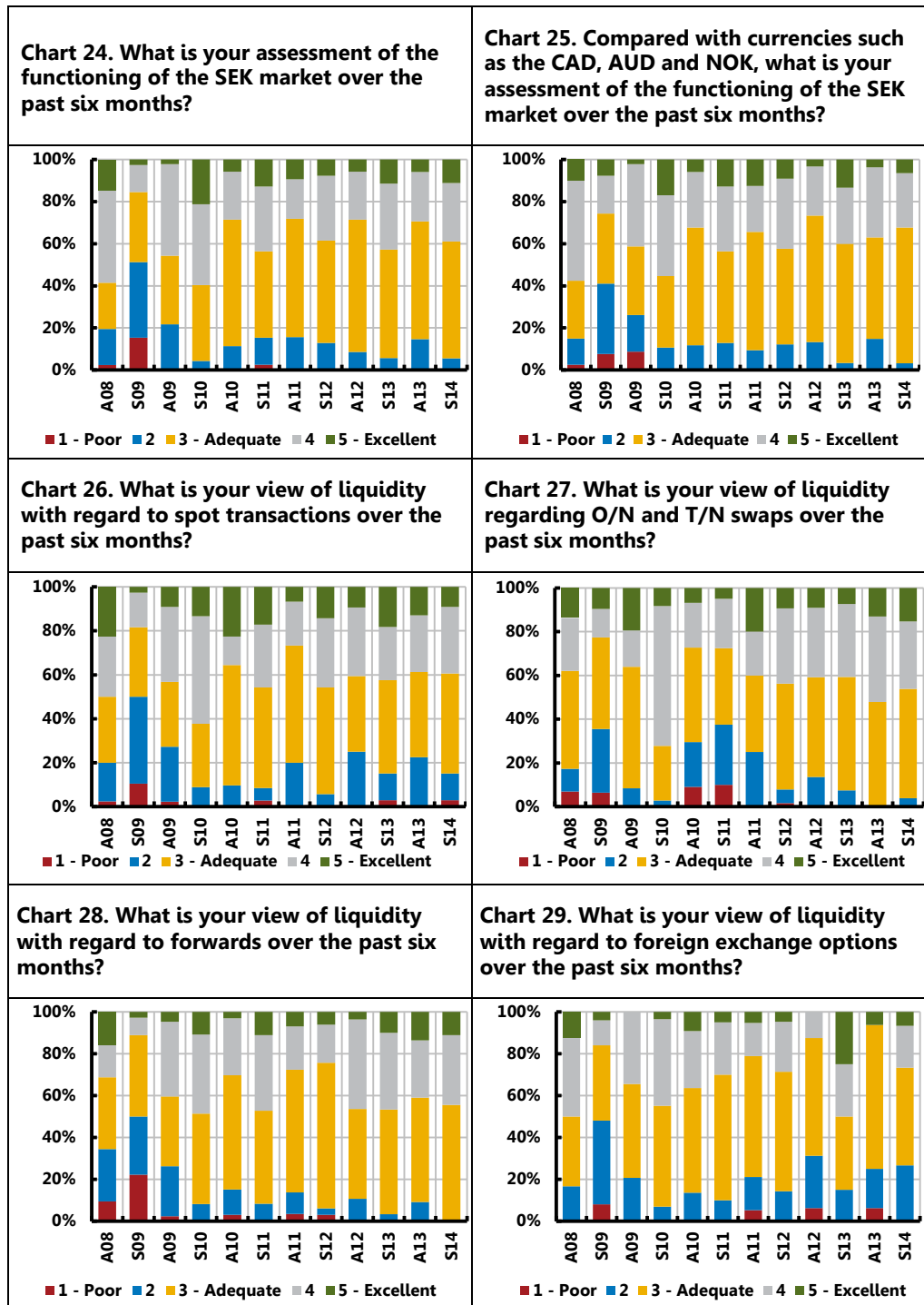


¹⁵ RIBA futures are a standardised forward that is based on the outcome of the Riksbank's repo rate. The contract basis is a fictitious loan, i.e. the underlying loan sums are not transferred. The maturity corresponds to the period between two IMM dates and the contract undergoes final settlement against the average repo rate for the period in question.

¹⁶ 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).

¹⁷ 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 MARKET¹⁸



¹⁸ 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.

Appendix 1 - Response frequency in earlier risk surveys and further examination

Below is a compilation of respondents' replies in earlier surveys to a number of questions regarding market functioning and their risk propensity. The appendix also includes a further examination of how the participants assess the development of various risks since the previous risk survey.

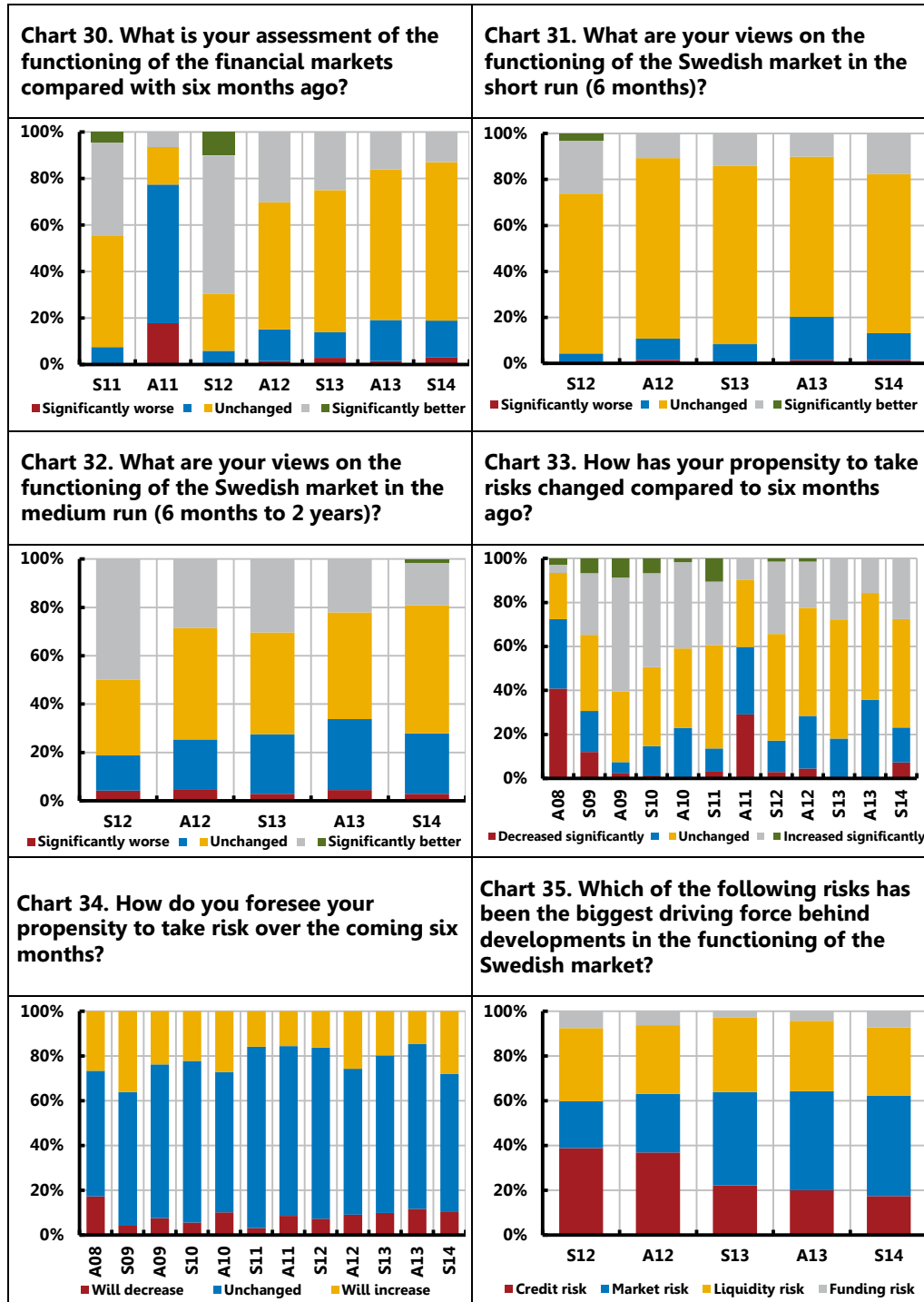


Chart 36. The respondents' assessment of how the selected risks in Chart 2 have developed over the past six months

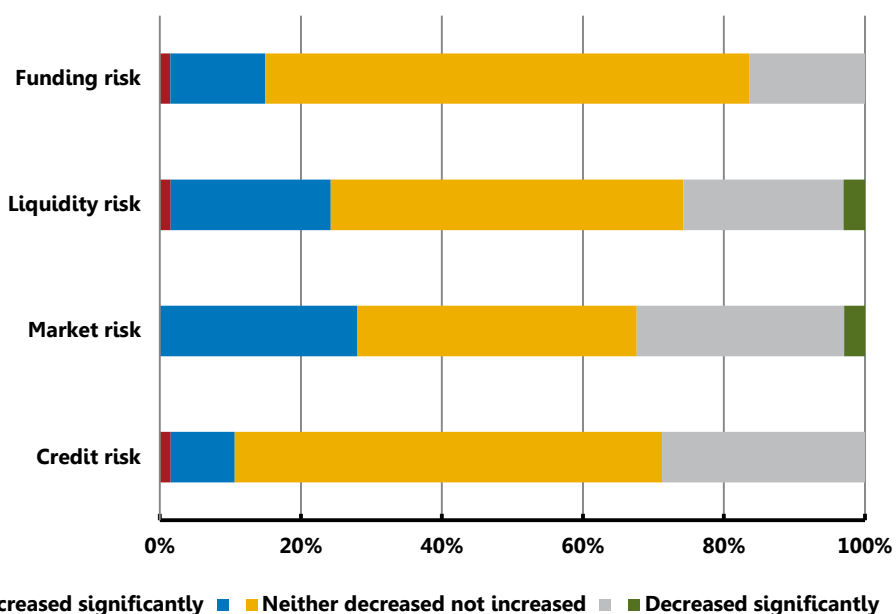
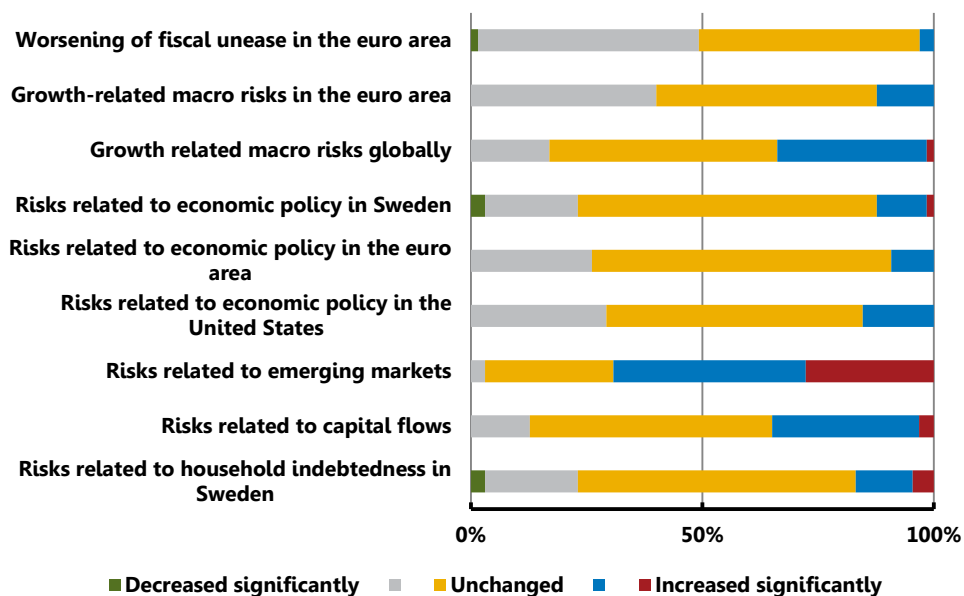


Chart 37. The respondents' assessment of whether the probability of the selected risk factors in Table 1 has changed since the previous risk survey



Appendix 2 - Open-ended questions related to the functioning of the fixed-income and foreign exchange markets

Below follow a number of open-ended questions the Riksbank has put to the survey respondents. The questions cover subjects that have been topical during the period since the previous risk survey and may have particular significance for the way the Swedish financial markets function.

- Which regulation has had the greatest impact on the functioning of the Swedish financial market over the past six months? In what way?
- In what way do you expect future regulations to affect the functioning of the Swedish financial markets? Which regulations do you have in mind here?
- How do you consider that Swedish market makers' behaviour has changed over the past six months? What factors do you think have caused this change? Has this development had any consequences for the way the Swedish market functions?
- How do you consider that interest in issuing or investing in Swedish corporate bonds has changed over the past six months? Which factors do you think have caused this change? What risks do you see on the Swedish corporate bond market?
- Interest in investing in the Riksbank's weekly certificates has fluctuated over the past year. What consequences of this fluctuation do you see on the short-term Swedish fixed-income market?