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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

One respondent in three responding to the Riksbank's risk survey in the autumn of 2014 considers that the Swedish financial markets function slightly less well than they did six months ago. In addition, one respondent in four expects functionality to deteriorate further over the next six months. The respondents report that the extended period of low interest rates is leading investors in search of yield to continue to turn to higher-risk investments. In parallel with this, the respondents consider that market liquidity for such assets in particular has deteriorated compared with six months ago. According to the respondents, liquidity has also decreased slightly in general, which they consider to be due to market makers being less willing than previously to take risks and to various regulations making trading more expensive. Overall, the respondents feel that risks related to geopolitical conflicts have increased at the same time as they continue to take a serious view of the possible consequences of an escalation of risks linked to Swedish households' indebtedness.

THE PROPORTION OF RESPONDENTS CONSIDERING THAT THE FUNCTIONING OF THE SWEDISH FINANCIAL MARKETS HAS DETERIORATED SLIGHTLY HAS DOUBLED

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 the spring of 2014 (see Chart 1). However, one respondent in three considers that the markets are functioning slightly less well, which is twice as many as six months ago (see Chart 24). Above all, investors and market makers are more negative and several of them state that this is due to liquidity on the financial markets now being lower (see Charts 10–23 for the respondents' assessment of liquidity). According to the respondents, this is due to market makers being less willing to take risks than previously and to various regulations having made trading more expensive for both market makers and other participants (see also p. 9–10). The respondents also consider that the low volatility on the financial markets has contributed to lower turnover, which has decreased liquidity.

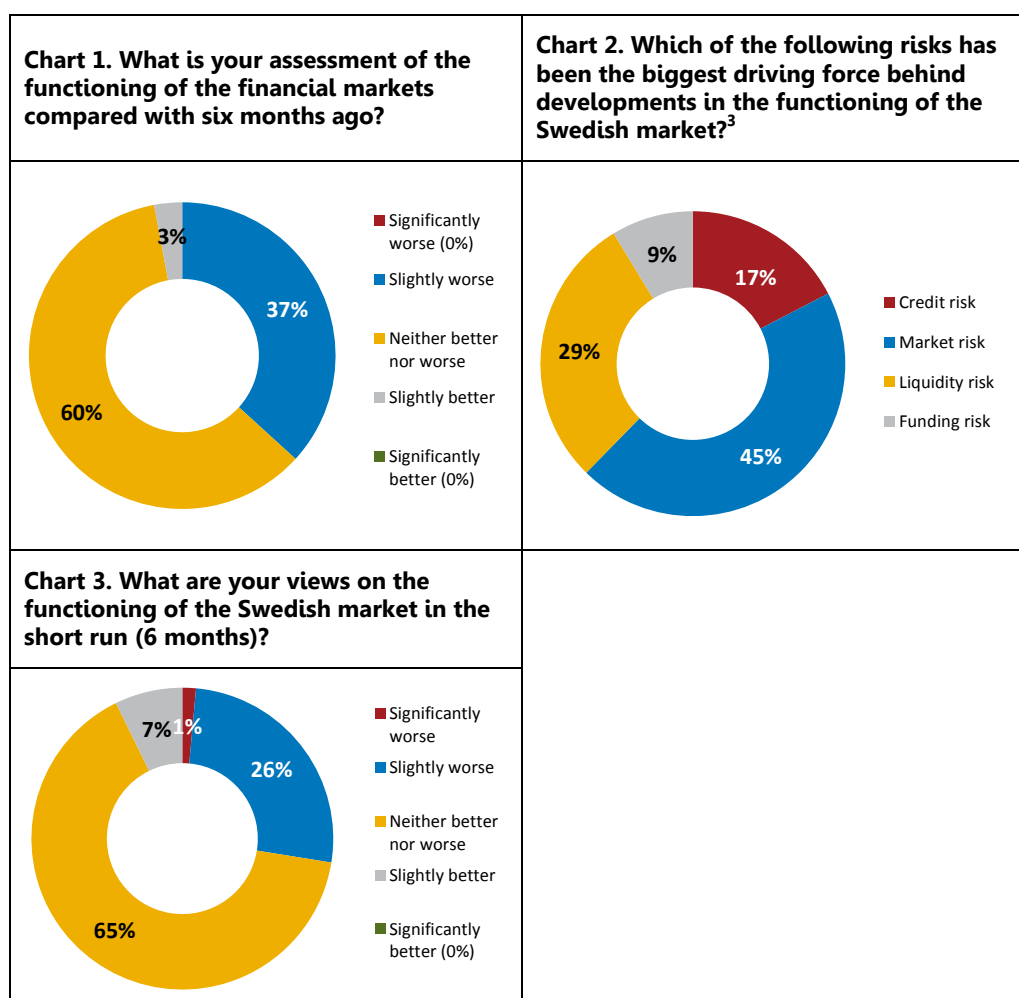
¹ With effect from spring 2008 the Riksbank has sent out a risk questionnaire twice a year to participants in the Swedish fixed-income and foreign exchange markets. The purpose of the survey is to gain an overall picture of the view of risk and the functioning of the Swedish financial markets. The survey only refers to the Swedish financial system. This report describes the results of the Riksbank's risk survey where responses were received between 18 September and 3 October 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 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 88 per cent.

² Throughout this survey, the terms 'the previous risk survey' or 'the spring risk survey' refer to the risk survey conducted by the Riksbank in March 2014.



Over the past six months, the respondents say that liquidity and, above all, market risks 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. There is no difference in opinion between different types of respondent as regards which risk has been the main driving force of this development.

The respondents are not on the whole expecting any major changes in the market functioning in the next six months (see Chart 3). However, the proportion expecting a deterioration in functionality has doubled since the previous survey and now amounts to one respondent in four (see Chart 25). Investors are generally more negative than borrowers and several of them state that they expect liquidity on the financial markets to continue to decline as a consequence of the introduction of new regulations which are increasing reporting requirements and administrative costs.



³ Credit risk refers to the risk that counterparties and issuers will be unable to meet their commitments; market risk refers to volatility in prices and interest rates; liquidity risk refers to the risk that an investment cannot be converted to liquid funds without a substantial loss of value or at all; and funding risk refers to the own organisation's access to liquid funds/funding.



RESPONDENTS ARE INCREASINGLY UNEASY OVER GEOPOLITICAL CONFLICTS

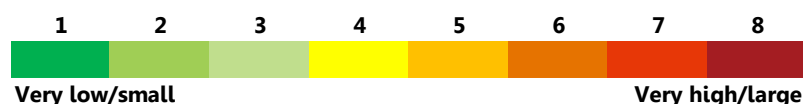
The respondents have assessed a number of pre-defined risks that could have negative consequences for the Swedish financial system if realised during the coming six to twelve months (see Table 1). They consider that there is a relatively high probability that risks linked to geopolitical unease will increase and result in negative consequences for the Swedish financial system. As examples, several respondents mention the geopolitical conflict between Russia and Ukraine, as well as various conflicts in the Middle East. The respondents assess that the possible consequences for the Swedish system could be relatively severe.

The respondents still take the most serious view of the possible consequences of the high level of debt in the Swedish household sector. In addition, the probability that risks related to Swedish households' indebtedness will become exacerbated is deemed to have increased since the previous risk survey. As an example, a number of respondents state their unease that housing prices could fall if the Swedish authorities introduce too drastic measures. However, the respondents' answers show that there are mixed opinions regarding how likely this is and how severe any consequences could be.

Risks linked to developments in the euro area are still considered to be tangible and the probability that the situation will deteriorate, with negative consequences for the Swedish financial system as a result, is deemed to have increased slightly over the last six months. This applies to the risks linked to economic growth, or lack of it, to economic policy and to developments in public finances. Several respondents considered that the banking system in Europe⁴ continues to be unstable and that many people are uneasy over growth in France. The respondents' answers display relative disagreement over how probable these risks are and how major the consequences could be.

The respondents participated in the survey a few days after the Swedish general election and deemed then that the probability of risks related to Sweden's economic policy being realised had increased. However, the respondents' answers show that there is a divided view of how likely this is and of how large the consequences could be.

⁴ The respondents participated in the survey before the result of the ECB's asset quality review and stress test of European banks had been published.

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 sovereign risk concerns and/or real economic growth in the euro area	4.7	4.9
Worsening real economic growth globally	4.8	5.0
Risks related to economic policy ¹ in Sweden	4.6	5.0
Risks related to economic policy ¹ in the euro area	5.0	4.9
Risks related to economic policy ¹ in the US	4.2	4.2
Risks related to geopolitical concerns	5.5	5.2
Risks related to emerging markets	4.7	4.5
Risks related to capital flows	4.5	4.5
Risks related to Swedish household debt	4.7	5.5

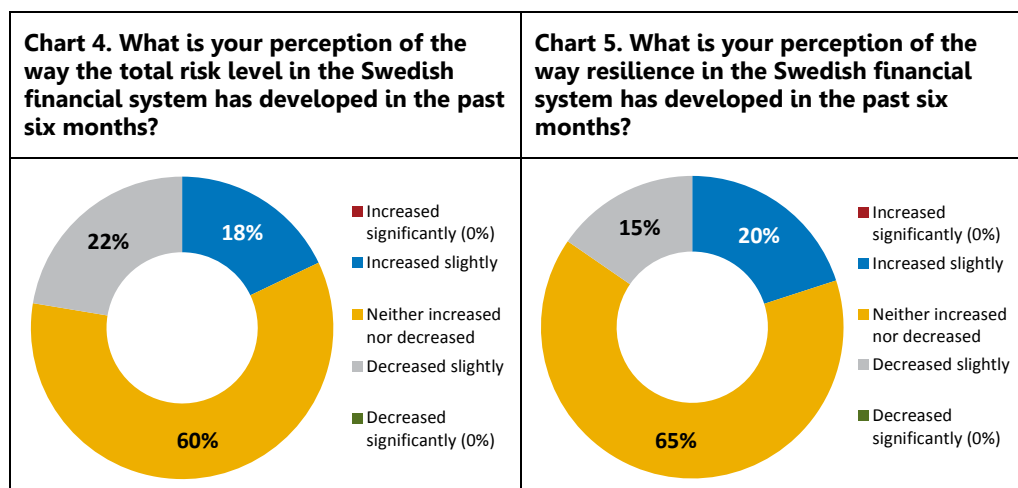
¹ Economic policy refers to both monetary and fiscal policy.

THE LEVEL OF RISK AND THE RESILIENCE OF THE SWEDISH FINANCIAL SYSTEM ARE DEEMED TO BE UNCHANGED

Without assessing individual risks, the respondents have also presented their view of the overall risk level and the resilience of the Swedish financial system. Most of them consider that both the level of risk and resilience have remained unchanged over the past six months (see Charts 4 and 5).

The respondents considering that the total risk level in the system has increased slightly are approximately as many as those considering that it has decreased slightly. One respondent in five considers that the risk level has increased slightly, and most of them are investors. Several of them explain developments by saying that many investors are seeking higher-risk investments to attain a higher yield than from government bonds, for example. In addition, several respondents consider that the overall risk level has increased slightly due to the political situation in Sweden directly after the general election and the geopolitical conflict between Russia and Ukraine.

One-fifth of the participants consider that the resilience of the financial system has increased slightly over the last six months and several actors consider that the reason for this lies with the new capital adequacy regulations for Swedish banks. The respondents instead considering that resilience has decreased slightly explain this by an absence of measures to dampen Swedish households' indebtedness.



INCREASED UNCERTAINTY AT A GLOBAL LEVEL HAS REDUCED THE RESPONDENTS' PROPENSITY TO TAKE RISK

Most of the respondents state that their propensity and mandate to take risk is unchanged compared to six months ago (see Charts 6 and 8). At the same time, one respondent in three considers that his or her own propensity to take risk has decreased, which is slightly more than in the previous survey (see Chart 26). It is primarily respondents on the foreign exchange markets who have become less willing to take risk and several of them explain this as the result of increased international uncertainty due to geopolitical conflicts and other developments. In parallel with this, fewer respondents than in the previous risk survey state that they have increased their willingness to take risk over the period (see Chart 26).

Most of the respondents believe that their propensity to take risk and their possibility to do so will remain unchanged during the coming six months (see Charts 7 and 9). Compared with the previous risk survey, twice as many respondents expect their propensity to take risk to decrease somewhat in the period ahead. The respondents explain this by stating that the increased international uncertainty makes it more difficult to judge how the financial markets will develop in the period ahead. At the same time, the proportion of respondents expecting their propensity to take risk to increase slightly has decreased against six months ago (see Chart 27).

Chart 6. How has your propensity to take risks changed compared to six months ago?

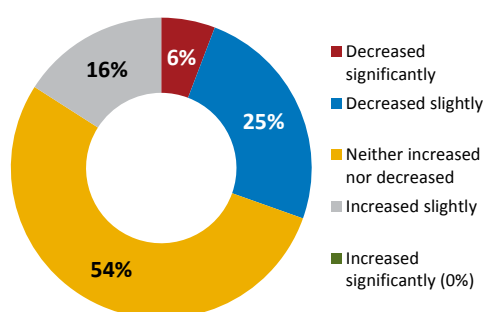


Chart 7. How do you foresee your propensity to take risk over the coming six months?

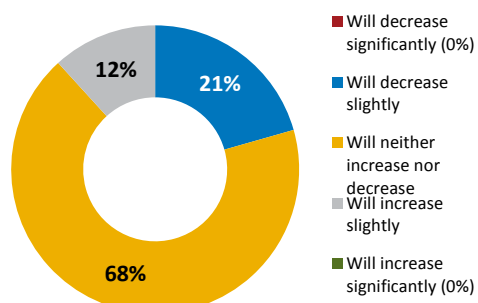


Chart 8. How has your scope/mandate to take risk changed compared to six months ago?

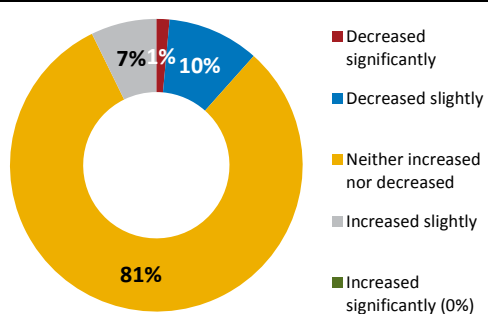
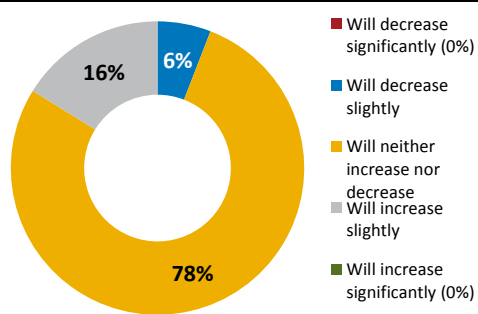


Chart 9. How do you foresee your scope/mandate to take risk over the coming six months?





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

The Riksbank also posed a number of open-ended questions to the market participants.⁵ 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.

THE RESPONDENTS SEE RISKS IN AN EXTENDED PERIOD OF LOW INTEREST RATES

Several of the respondents to the survey are uneasy over risks linked to the long period of low interest rates. According to the respondents, continued low interest rates risk increasing Swedish households' incentive to borrow. They perceive this as problematic as many of them already consider that household indebtedness is not sustainable in the long term. A few respondents expect that households will have to reduce their consumption in the period ahead so as to be able to amortise their debts.

The respondents also report that an extended period of low interest rates will lead investors in search of yield to turn to higher-risk investments. Several respondents consider that the yield generated by such investments is not sufficient in relation to the risk taken. According to the respondents, the search for yield risks leading to a mispricing of risk and to an accumulation of bubbles in various asset classes on the financial markets.

THE RESPONDENTS ARE DEMANDING MORE TRANSPARENCY ON THE MARKET FOR CORPORATE BONDS

As in the previous risk survey, the respondents considered that interest in corporate bonds is continuing to increase among both issuers and investors. Many respondents feel that the low interest rates that have characterised the financial markets over a longer period of time have led to investors continuing to search for higher-risk investments, such as corporate bonds, as the expected return is higher for these than for government bonds, for example.

Respondents also continue to 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.⁶ The respondents see risks in this, as a situation in which many investors wish to sell their holdings at the same time could create risks such as price volatility. Almost half of the respondents on the fixed-income market deemed that liquidity for corporate bonds was not at an acceptable level on the date of response (see Chart 13).

Several respondents, above all borrowers, state that transparency needs to be improved on the market for corporate bonds. Above all, they demand more information on the trading taking place on the secondary market, and mention, as examples, turnover volumes and prices for executed transactions. In June 2014, Finansinspektionen presented a proposal⁷ to increase the

⁵ Appendix 2 contains a compilation of the open questions the Riksbank put to respondents.

⁶ For more information on how the market for corporate bonds functions, see Bonthron, F, The development of the Swedish market for corporate bonds, Economic Commentary no. 7 2014, Sveriges Riksbank.

⁷ In June 2014, Finansinspektionen put forward a proposal to increase the transparency of the Swedish secondary market for corporate bonds. Sweden has regulations requiring information on bond trading to be published by no later than 09.00 on the following day (see the Securities Market Act (2007:528) and Finansinspektionen's regulations governing operations on trading venues (FFFS 2007:17)). This takes place in the markets for government and covered bonds on Nasdaq's website. Finansinspektionen had previously chosen to exempt corporate bonds from this requirement but, as the market is growing and



transparency of the Swedish secondary market for corporate bonds. During the period in which the respondents were completing the risk survey, this proposal was being circulated for comment and was yet to be adopted.⁸

RESPONDENTS PREDICT POORER LIQUIDITY ON FIXED-INCOME MARKET AS A RESULT OF REGULATIONS

Several respondents consider that upcoming regulations to increase the transparency of the financial markets will result in lower market liquidity. The main examples cited by the respondents are the upcoming regulations in the MiFID II directive and the MiFIR⁹ regulation. The introduction of these regulations in 2016 will involve requirements for increased transparency surrounding the prices of transactions on the bond market. Several respondents are critical of this regulatory framework and argue that it will reduce liquidity on the bond market as they consider that incentives to act as market maker will decrease if executed transactions are published. However, it has yet to be decided exactly how this regulatory framework will be designed.

Many respondents already perceive a decreasing propensity to take risk among market makers. 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 both introduced and upcoming capital adequacy requirements.

In addition, several respondents are uneasy about the market makers' ability to maintain liquidity on certain markets in a stressed situation. For example, in a situation in which the number of sellers exceeds the number of buyers, the respondents consider that the market makers' ability would vary for different bond types. Maintaining liquidity on the market for government bonds would not be a problem, but it would, however, be more difficult on the market for covered bonds. As regards the market for corporate bonds, most of the respondents regard the market makers' ability to maintain liquidity, for example under increased sales pressure, as low. Compared with the previous risk survey, the respondents perceive that liquidity among all bond types mentioned has deteriorated slightly and that liquidity for corporate bonds is the lowest of the three (see Charts 11–13).

Several respondents consider that the regulation of derivatives trading on the OTC market¹⁰ through EMIR¹¹ will have a negative effect on the functioning of the Swedish financial markets.¹² The respondents have held this opinion for the last two years. They still 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

more smaller participants have appeared, Finansinspektionen proposed that trade in corporate bonds be reported in the same way.

⁸ In October 2014, it was resolved to implement the proposal, starting in February 2015.

⁹ The Markets in Financial Instruments Directive II (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR) are a reworking of the MiFID directive that was introduced across the EU in 2007.

¹⁰ OTC stands for "over the counter" and refers to trade between two parties that is not conducted on a regulated or organised marketplace.

¹¹ 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.

¹² 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.



trading derivatives contracts, which is included in EMIR, will make this form of trading more expensive, among other reasons because investments need to be made in technical systems. 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.

Liquidity in the Swedish fixed-income and foreign exchange markets¹³

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.¹⁴

LIQUIDITY ON THE SWEDISH FIXED-INCOME AND FOREIGN EXCHANGE MARKETS IS CONSIDERED TO BE SLIGHTLY DIMINISHED

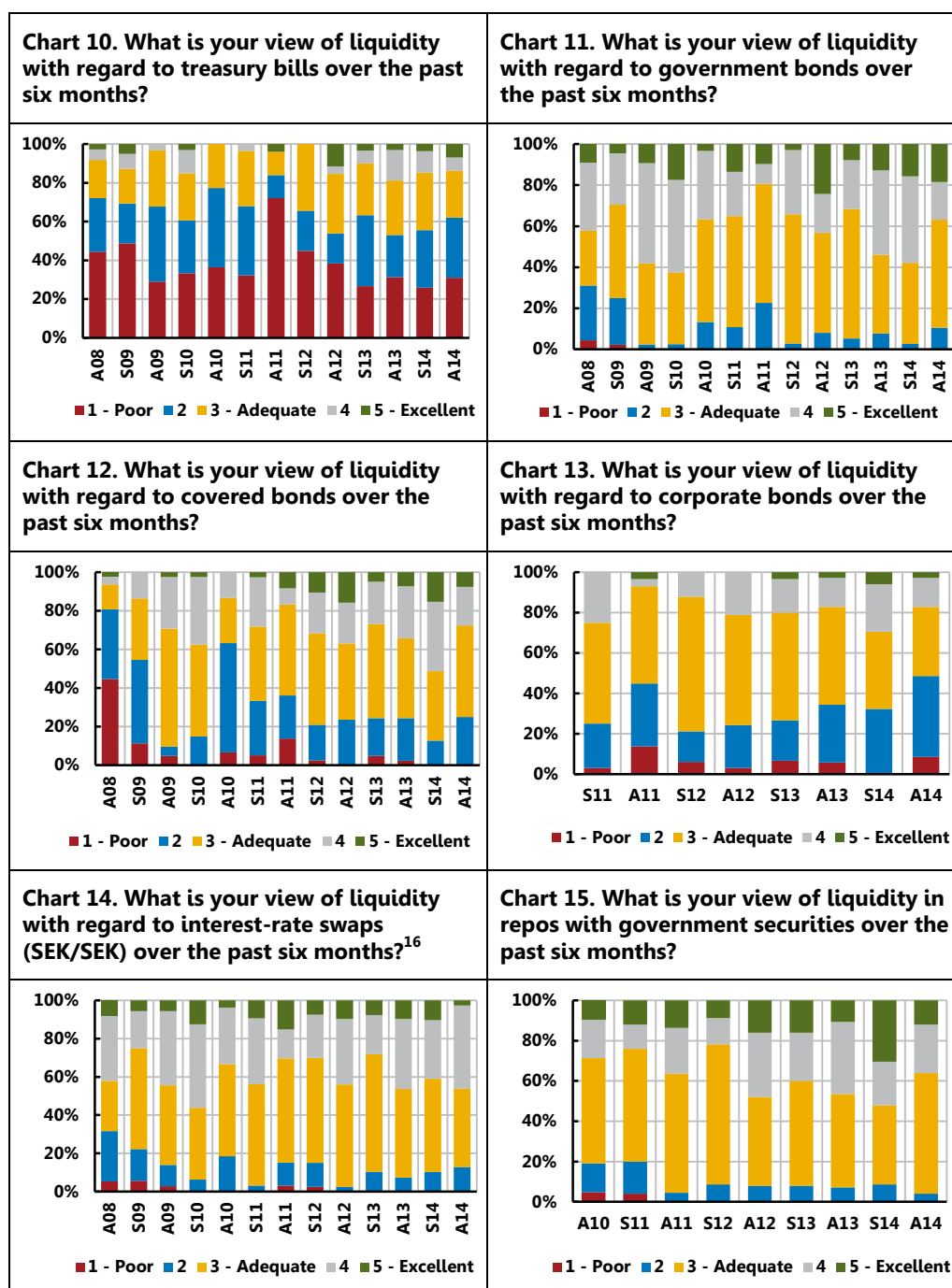
As in the previous risk survey, the liquidity in the various instruments on the Swedish fixed-income and foreign-exchange markets is generally considered to be acceptable by the respondents. However, as mentioned above, increasing number of respondents state that the Swedish financial markets are functioning slightly less well than previously (see Chart 1) and many report that this is due to lower liquidity. The respondents perceive a slight impairment of liquidity for the majority of instruments but, above all, for instruments on the fixed-income market. For example, almost half of the respondents on the fixed-income market consider that liquidity for corporate bonds is below an acceptable level (see Chart 13).

STINA swap instruments also stick out as more than half of respondents on the fixed-income market consider that liquidity is not acceptable (see Chart 18). Only one respondent in five stated this six months ago. The instrument is closely linked to the functioning of the short-term Swedish fixed-income market but the respondents do not give any specific explanation for the impaired liquidity.

¹³ When interpreting market participants' responses in Figures 10 to 23 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.

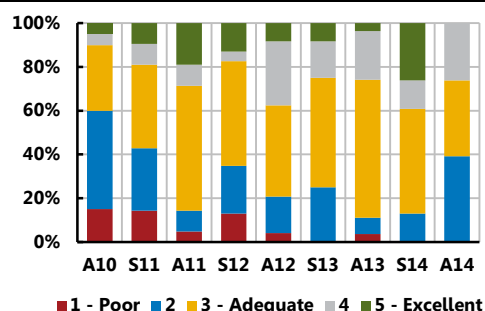
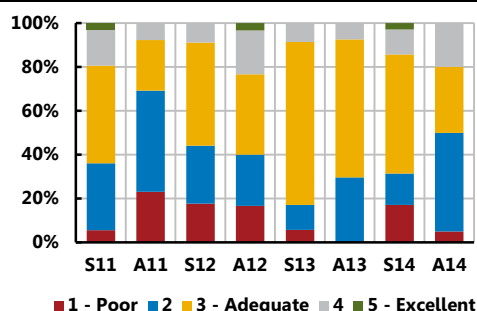
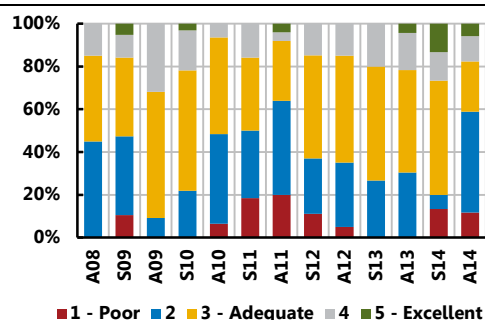
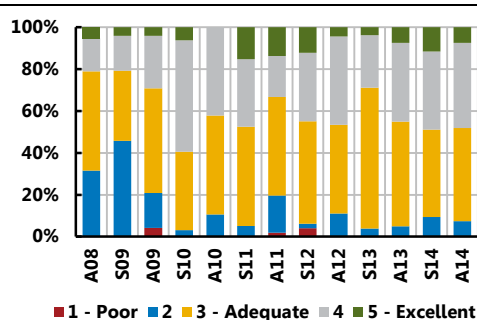
¹⁴ Survey respondents were asked to assess how liquidity had been for the specific instrument on the basis of how easy it has been to sell large volumes and how large the difference between buying and selling prices has been. They were asked to rate on a scale of 1 to 5, where 1 is poor and 5 is excellent.

MARKET PARTICIPANTS' ASSESSMENT OF THE LIQUIDITY IN INSTRUMENTS ON THE SWEDISH FIXED-INCOME MARKET¹⁵



¹⁵ 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.

¹⁶ An interest-rate 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.

Chart 16. What is your view of liquidity in repos with covered bonds over the past six months?

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

Chart 18. What is your view of liquidity with regard to STINA swaps over the past six months?¹⁸

Chart 19. 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 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.

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 MARKET²⁰

Chart 20. What is your assessment of the functioning of the SEK market over the past six months?

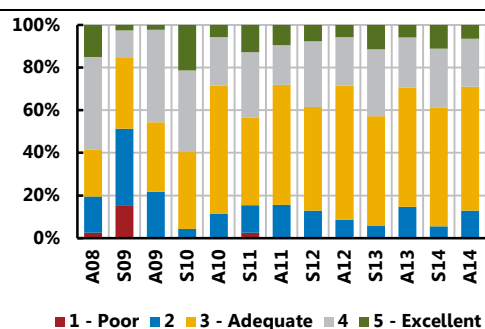


Chart 21. Compared with currencies such as the CAD, AUD and NOK, what is your assessment of the functioning of the SEK market over the past six months?

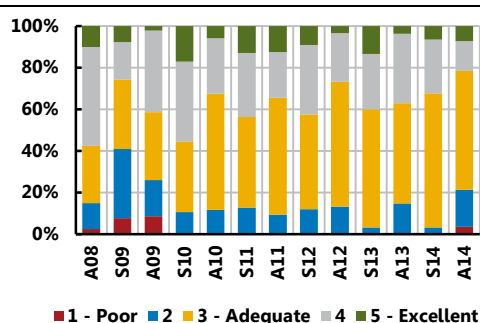


Chart 22. What is your view of liquidity with regard to spot transactions over the past six months?

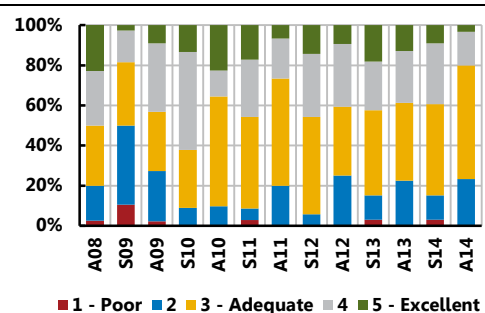
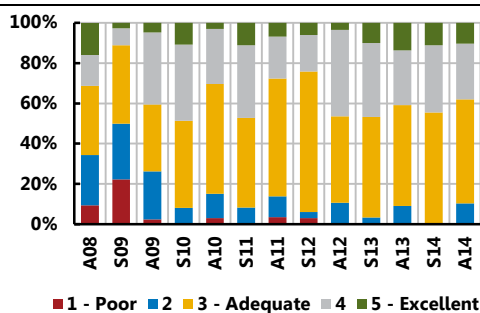


Chart 23. What is your view of liquidity with regard to forwards over the past six months?



²⁰ 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.

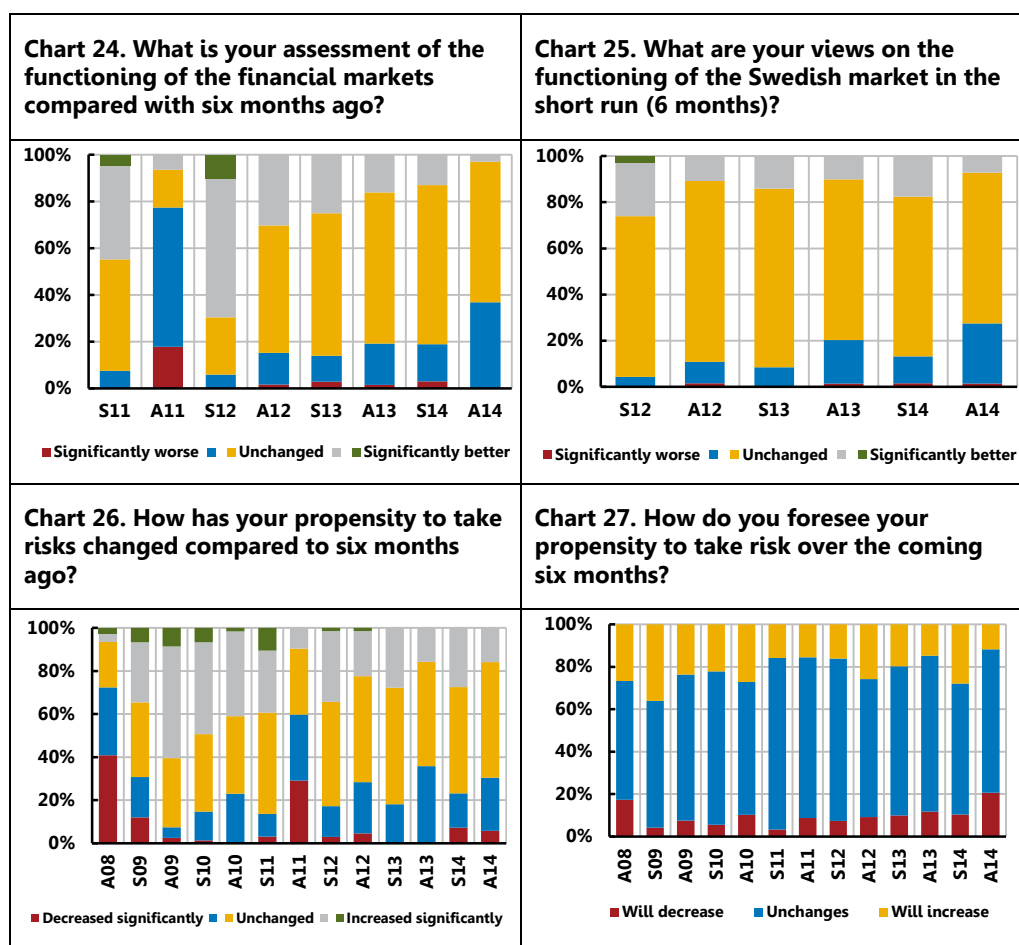


Chart 28. Which of the following risks has been the biggest driving force behind developments in the functioning of the Swedish market?

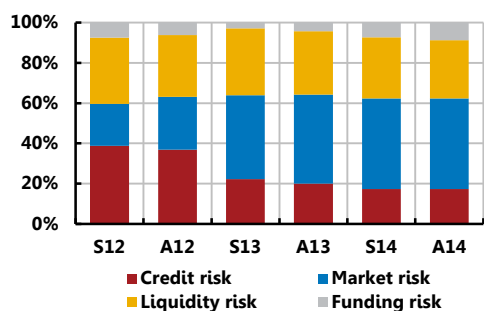
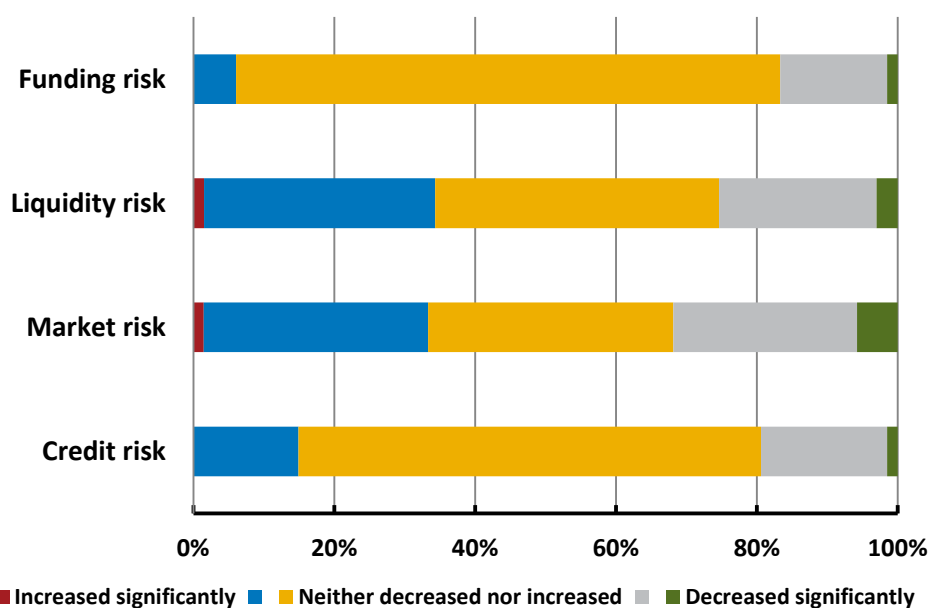


Chart 29. The respondents' assessment of how the selected risks in Chart 2 have developed over the past six months



**Table 2. The respondents' assessment of selected risks that can affect the Swedish financial system, spring 2014**

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.



Appendix 2 - Open-ended questions related to the functioning of the Swedish 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 assess the market makers' possibilities to maintain a liquid market in a stress scenario? With regard to government bonds? With regard to covered bonds? With regard to corporate bonds?
- Interest in issuing and investing in the Swedish corporate bond market is increasing. Do you see any risks with this development? How do you perceive the functioning of the market? Does it need to change in any way?
- Do you see any risks related to an extended period with low interest rates?