

DNR 2013-275-AFS



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

AUTUMN 2013



■ 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 during autumn in 2013. Overall, the total level of risk and resilience in the Swedish financial system is regarded to be relatively unchanged since the spring survey. Developments in the euro area still constitute a considerable risk to the Swedish financial system according to the respondents, although the risks are thought to have declined somewhat since spring. However, the respondents have a somewhat more negative view of future developments than in previous surveys. Several of them mention that over the past six months the financial markets have been characterised by uncertainty regarding the potential effects of reduced central bank stimulus and over when the reduction will occur. A majority of the respondents also believe that both their propensity and possibility to take on risk will remain unchanged in the coming period as a result of this uncertainty. Several of them also state that they are uncertain about the details of coming financial regulations and believe that these regulations will lead to fewer market participants and thus poorer liquidity.

THE SWEDISH FINANCIAL MARKETS ARE FUNCTIONING WELL DESPITE UNCERTAINTY REGARDING CENTRAL BANK MEASURES

The majority of the respondents consider the functioning of the Swedish financial markets to be unchanged since spring, when the previous risk survey² was conducted (Chart 1). However, the share of respondents who consider that the markets are functioning slightly worse has increased since the spring survey and previous surveys (Chart 30).³ Overall, the market makers⁴ are less positive regarding the functioning of the markets as compared to investors and borrowers. Several respondents say that over the past six months the Swedish markets have been characterised by uncertainty over when the central banks⁵ will reduce their stimulus and what effects this will have. Uncertainty over the details of coming financial regulations and a reduced

¹ Since spring 2008 the Riksbank sends 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 gain an overall picture of their 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 19 September and 7 October 2013. The Riksbank commissioned the 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 autumn survey was sent out to 79 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 90 per cent.

² References to the previous risk survey or the spring risk survey all refer to the risk survey carried out in March and April 2013, which covered the period October 2012 to March 2013.

³ Appendix 1 contains the respondents' answers to a number of questions from the previous risk surveys.

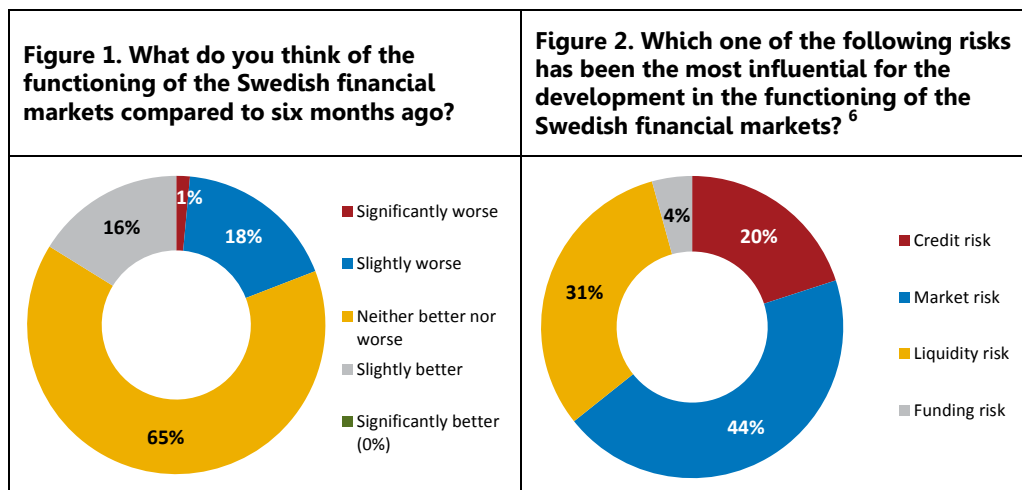
⁴ A Market Maker is a market participant who has undertaken to regularly quote bid and ask prices on a particular security or securities to maintain a market.

⁵ Several central banks abroad are conducting an expansionary monetary policy through low policy rates. In the United States, the United Kingdom and Japan, the central banks are also using stimulus in the form of asset purchases and in the euro area the European Central Bank is offering unlimited loans against collateral to the banking system. The main focus during the past six months has been on when the Federal Reserve will reduce its asset purchases.



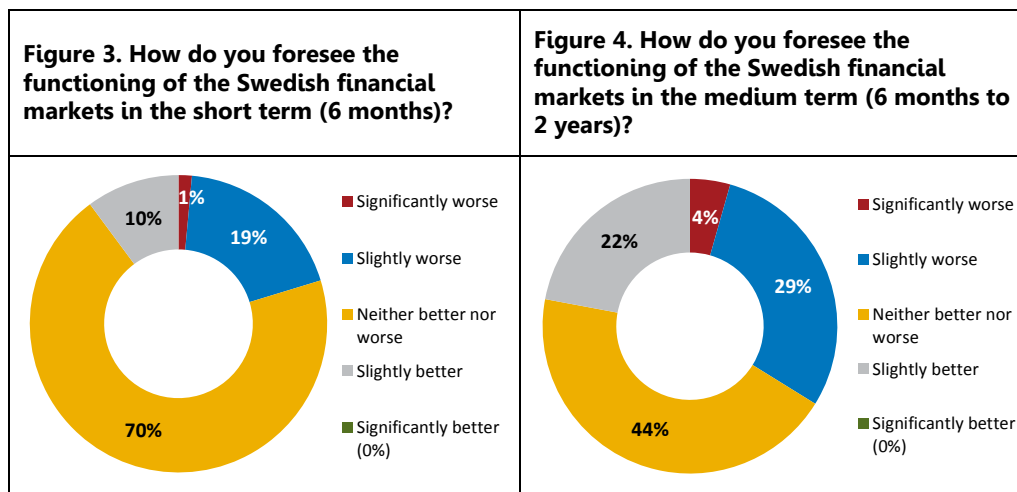
propensity to take on risk among market participants are also considered to have contributed to the deterioration in market functioning.

These factors are also said to have contributed to an increase in market risk and liquidity risk - the risks that, according to the respondents, have been the main driving forces behind developments in the functioning of the Swedish financial markets over the past six months (Chart 2). A majority of the respondents, primarily on the fixed-income market, say that the market risk has increased as volatility in prices and interest rates has been higher (Chart 36). Many respondents, particularly those on the foreign exchange market, also say that the liquidity risk has increased as turnover on the market has been lower. These risks were also considered as the main driving forces behind the development in the spring risk survey, although the respondents then found that they had declined.



Overall, the respondents are not expecting any major changes in the way the markets function over the coming period, neither in the short run (Chart 3), nor the longer run (Chart 4). However, when compared with the spring risk survey, a larger share of participants now believe that the markets will function slightly worse in the coming period (Charts 31 and 32). This is particularly apparent in the longer run, where almost one third of the respondents are expecting the markets to function slightly worse. Many of them state that they are uncertain about the details of coming financial regulations, which they believe will lead to fewer active market participants and thus poorer liquidity. Participants in the fixed-income market in general have a more negative view of market functioning than participants in the foreign exchange market.

⁶ Credit risk refers to the risk that counterparties and issuers become unable to meet their commitments, while 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.



DEVELOPMENTS IN THE EURO AREA STILL CONSTITUTE A MAJOR RISK TO THE SWEDISH FINANCIAL SYSTEM

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. The various risks linked to developments in the euro area are still considerable, according to the participants (Table 1). The consequences for the Swedish financial system of a worsening of the current sovereign debt crisis in the euro area, or alternatively a new crisis, could be severe. The respondents also consider the negative consequences that can follow from the economic policy or deteriorated growth in the euro area as potentially severe. However, the probability that these risks are to be realised is considered to have declined somewhat (Chart 37).

In addition, the respondents are still worried about the possible consequences stemming from a 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. The probability of this occurring is considered to have increased somewhat since the previous survey.

Expectations of a reduction in stimulus from the Federal Reserve, combined with a deteriorated economic outlook, led to increased capital outflows and higher volatility, in connection with investors reallocating their capital, during the summer of 2013. However, the respondents are not worried that the Swedish financial system will be negatively impacted by neither risks linked to capital flows nor deteriorated economic prospects in emerging markets. They are more concerned over global economic prospects.



Colour-coding for the scale of 1 to 8:

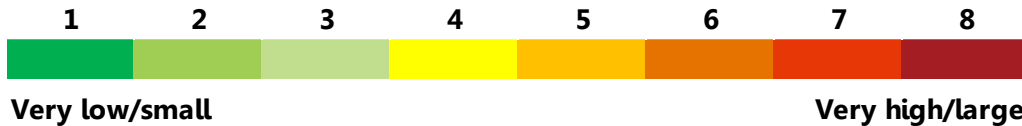
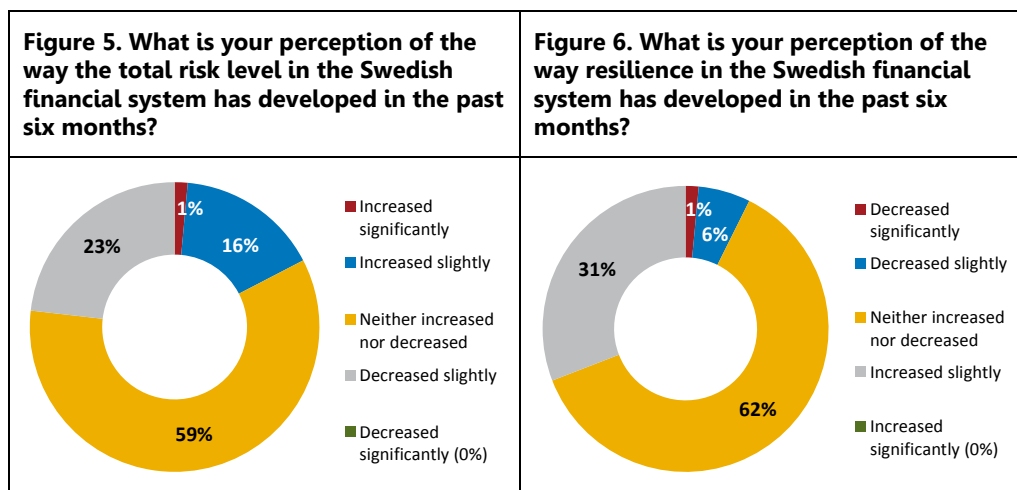


Table 1. The respondents' assessment of selected risks that can affect the Swedish financial system

Riskfactor	Probability	Consequence
Sovereign risk in the Euro area	4,8	5,8
Sovereign risk in the rest of the world	4,1	5,1
Growth related macro risks in the Euro area	5,0	5,5
Growth related macro risks globally	4,9	5,2
Growth related macro risks in emerging markets	5,4	4,6
Risks related to economic policy in Sweden	3,3	5,2
Risks related to economic policy in the Euro area	4,8	5,2
Risks related to economic policy globally	4,8	4,8
Risks related to capital flows	4,6	4,9
Swedish household debt	4,3	5,6

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 to realise. The respondents have also given their views of the overall risk level and resilience of the system. Most respondents consider both the level of risk and resilience to have remained fairly unchanged over the past six months (Charts 5 and 6). However, some participants state that it has improved compared to six months ago. According to some this is partly because the Swedish banks have strengthened their balance sheets. The participants in the fixed-income market are slightly more positive to how resilience and the level of risk have developed as compared to participants in the foreign exchange market.





UNCHANGED PROPENSITY TO TAKE ON RISK AMONG RESPONDENTS DUE TO UNCERTAINTY OVER CENTRAL BANK MEASURES

Almost half of the respondents state that their propensity to take on risk is unchanged compared to six months ago (Chart 7). At the same time, more than one third of the respondents say that their risk propensity has declined. It is mainly the market makers who are of this opinion. Borrowers to a large extent have an unchanged risk propensity, while the investors' responses are spread out. Participants in the foreign exchange market have to a greater extent had a decline in their risk propensity than participants in the fixed-income market. Several respondents mention that they are uncertain about the effects of reduced stimulus from the central banks and when these reductions will take place and that this has affected their propensity to take on risks. Several participants also mention that the markets recently have been characterised by lower liquidity and higher volatility in prices and interest rates. In the previous risk survey the propensity to take on risk had instead increased among one third of the respondents. The respondents then said, among other things, that the central banks' stimulus had helped to calm the markets. The opportunity to take on risk over the past six months is said to have remained fairly unchanged, however (Chart 8).

The majority of the respondents believe that their propensity and opportunity to take on risk will remain unchanged over the coming six months (Charts 9 and 10). At the same time, a larger share of the respondents, compared with previous surveys, believe that their propensity to take on risk will decline in the coming period (Chart 34). The participants in the foreign exchange market who state that they have had a reduced propensity to take on risk believe that it will continue to decline ahead. It is once again the uncertainty surrounding central bank measures that is said to create a cautious stance with regard to risk-taking in the coming period.

⁷ Many respondents also state in their responses to the Riksbank's open-ended questions that the Swedish market makers have become less willing to take on risk (page 7).



<p>Figure 7. How has your propensity to take on risk changed during the last six months?</p>	<p>Figure 8. How do you foresee your propensity to take on risk over the coming six months?</p>																								
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<p>Figure 9. How have your possibilities/mandates to take on risk changed during the last six months?</p>	<p>Figure 10. How do you foresee your possibilities/mandates to take on risk over the coming six months?</p>																								
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Open-ended questions related to the functioning of the fixed-income and foreign exchange markets⁸

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 for which the risk survey was carried out and may be of particular significance for the way the Swedish financial markets function.

RESPONDENTS SEE INCREASED COSTS RESULTING FROM REGULATIONS OF BANKS AND DERIVATIVES TRADING

Several respondents state that coming regulations for banks through Basel III⁹ and for derivatives on the OTC market¹⁰ through EMIR¹¹ affect the functioning of the markets. The respondents expressed similar opinions in the previous risk survey. The increased reporting requirements ensuing from both EMIR and Basel III is believed to lead to increased administrative costs. Several respondents believe that the requirement for central counterparty clearing when trading derivatives contracts, which is included in EMIR, will make it more expensive to trade in derivatives. Several of them also state that increased capital adequacy and liquidity requirements as a result of Basel III will lead to higher costs for the banks. The respondents are assuming that these costs will be passed on to the customers to a great extent and that market liquidity therefore will decline. Many respondents, particularly among market makers, also say that the US financial regulation, the Dodd-Frank Act¹², have an indirect effect on the Swedish financial markets, although they do not specify in what way.

DECREASED PROPENSITY TO TAKE ON RISK AMONG MARKET MAKERS

Many respondents state that Swedish market makers' propensity to take on risk has declined over the past six months, on both the fixed-income and foreign exchange markets. This assessment is made by both the market makers themselves and other market participants. Within the latter group, it is mainly investors in the fixed-income market who perceive that the propensity to take on risk has declined. This is considered to have contributed to a decline in liquidity on these markets. The participants say that the decline in risk propensity is due to regulations, and refer, for instance, to Basel III.

⁸ Appendix 2 contains a compilation of the open-ended questions the Riksbank posed to the respondents.

⁹ 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.

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 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, and it will be introduced gradually in stages.



INTEREST IN CORPORATE BONDS CONTINUE TO INCREASE

Interest in corporate bonds has continued to increase among both issuers and investors over the past six months, according to the survey respondents. Responses to the spring survey also indicated that interest had increased. According to many respondents, the low interest rate environment that has characterised the markets for some time has led to investors seeking alternative investments that can provide higher returns than, for instance, government bonds. This is said to have resulted in increased demand for corporate bonds. The low interest rate environment has also increased interest among companies for issuing bonds. Some respondents say that banking regulations will reduce the banks' willingness to lend and/or make their lending to companies more expensive. This is also considered to have contributed to greater interest among companies to issue.



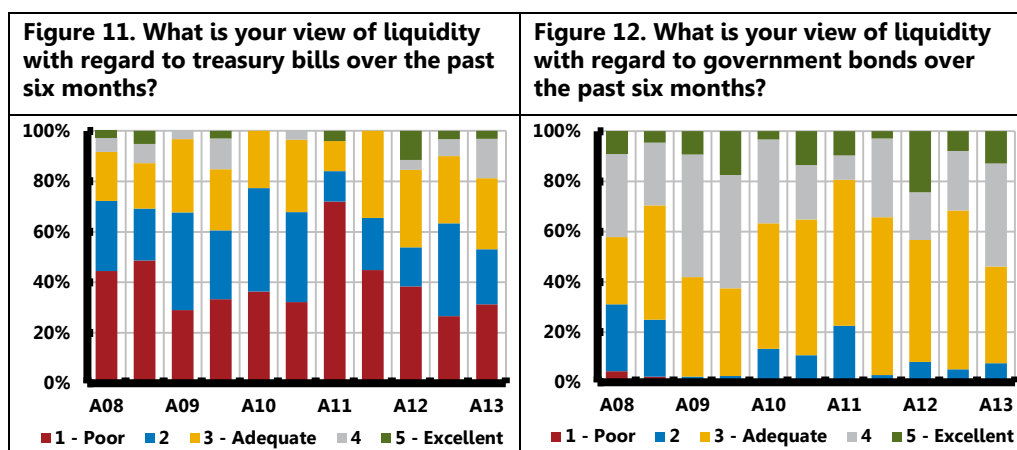
Liquidity in the Swedish fixed-income and foreign exchange markets¹³

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

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

The liquidity in the various instruments on the Swedish fixed-income and foreign exchange markets is generally considered to be adequate or better. It is on the whole difficult to discern any clear change in the respondents' views on liquidity on the fixed-income market. However, participants in the foreign exchange market appear to consider liquidity to have become somewhat poorer. For instance, several of them consider that the market for Swedish krona has functioned worse than the markets for several other currencies¹⁵ over the past six months (Chart 25). This also tallies with their responses to the question of which risks that have been the driving forces behind developments in the functioning of the markets. There, the participants in the foreign exchange market consider liquidity risk to have increased slightly since the previous risk survey (Charts 2 and 36).

MARKET PARTICIPANTS' ASSESSMENT OF THE LIQUIDITY IN INSTRUMENTS ON THE SWEDISH FIXED-INCOME MARKET¹⁶

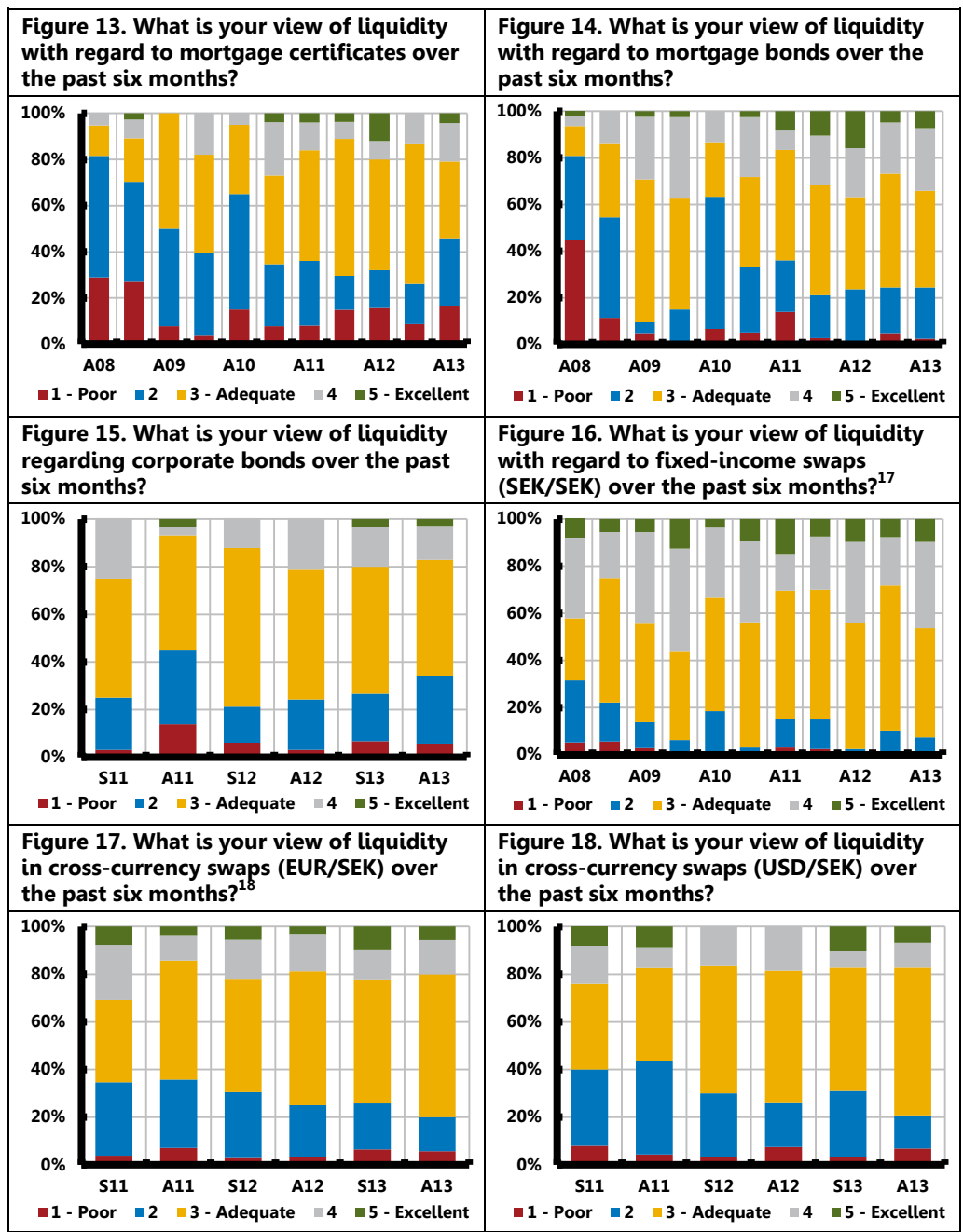


¹³ When interpreting market participants' responses in Figures 9 to 27, it is important to remember that the markets and the instruments are not necessarily comparable since they often have structural differences. It is therefore more appropriate to analyse changes over time for individual instruments than to compare different instruments.

¹⁴ 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.

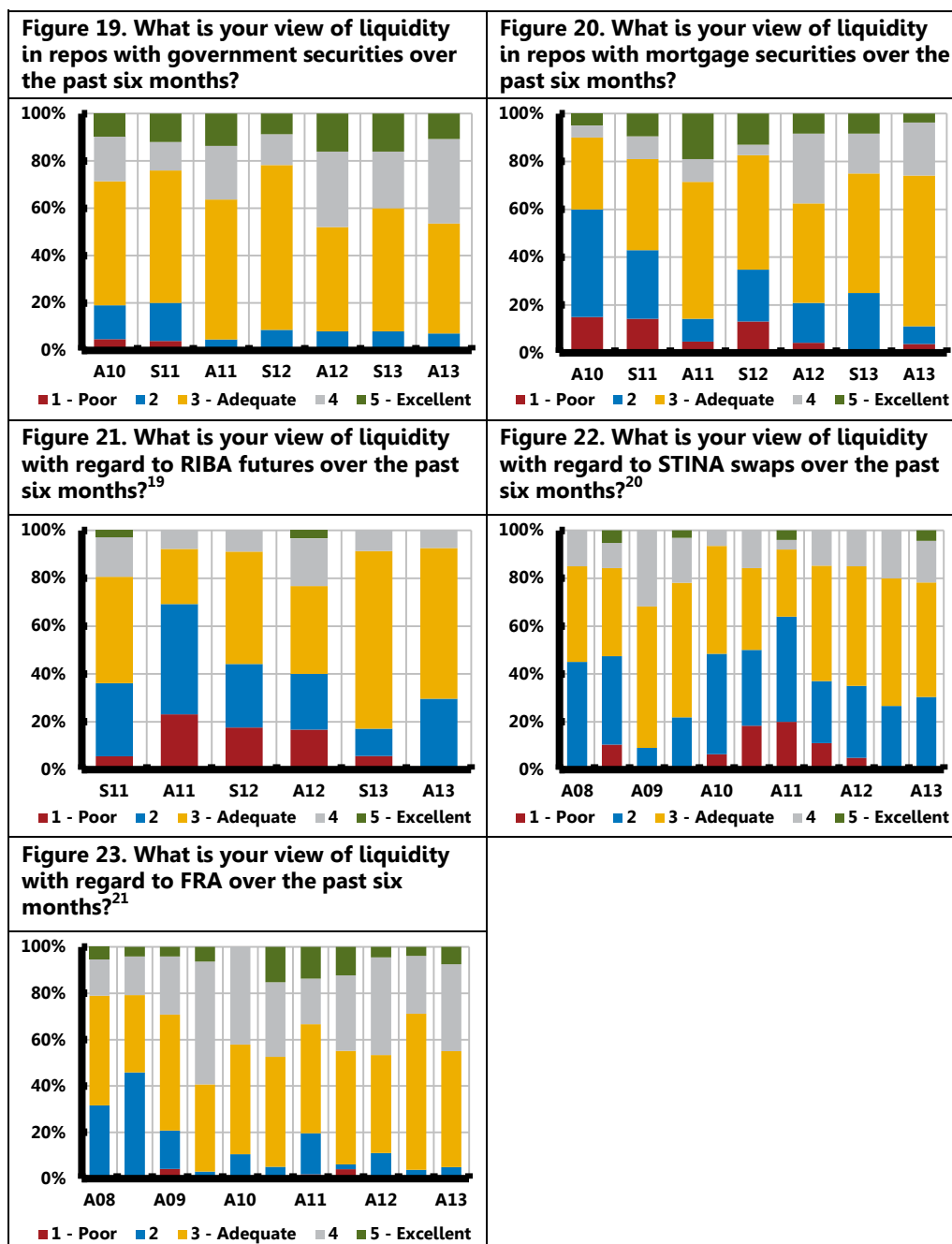
¹⁵ The participants were asked to assess how the market for Swedish krona has functioned in relation to the markets for currencies such as the Canadian dollar, the Australian dollar and the Norwegian krona.

¹⁶ 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.



¹⁷ 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.

¹⁸ 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.



¹⁹ 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.

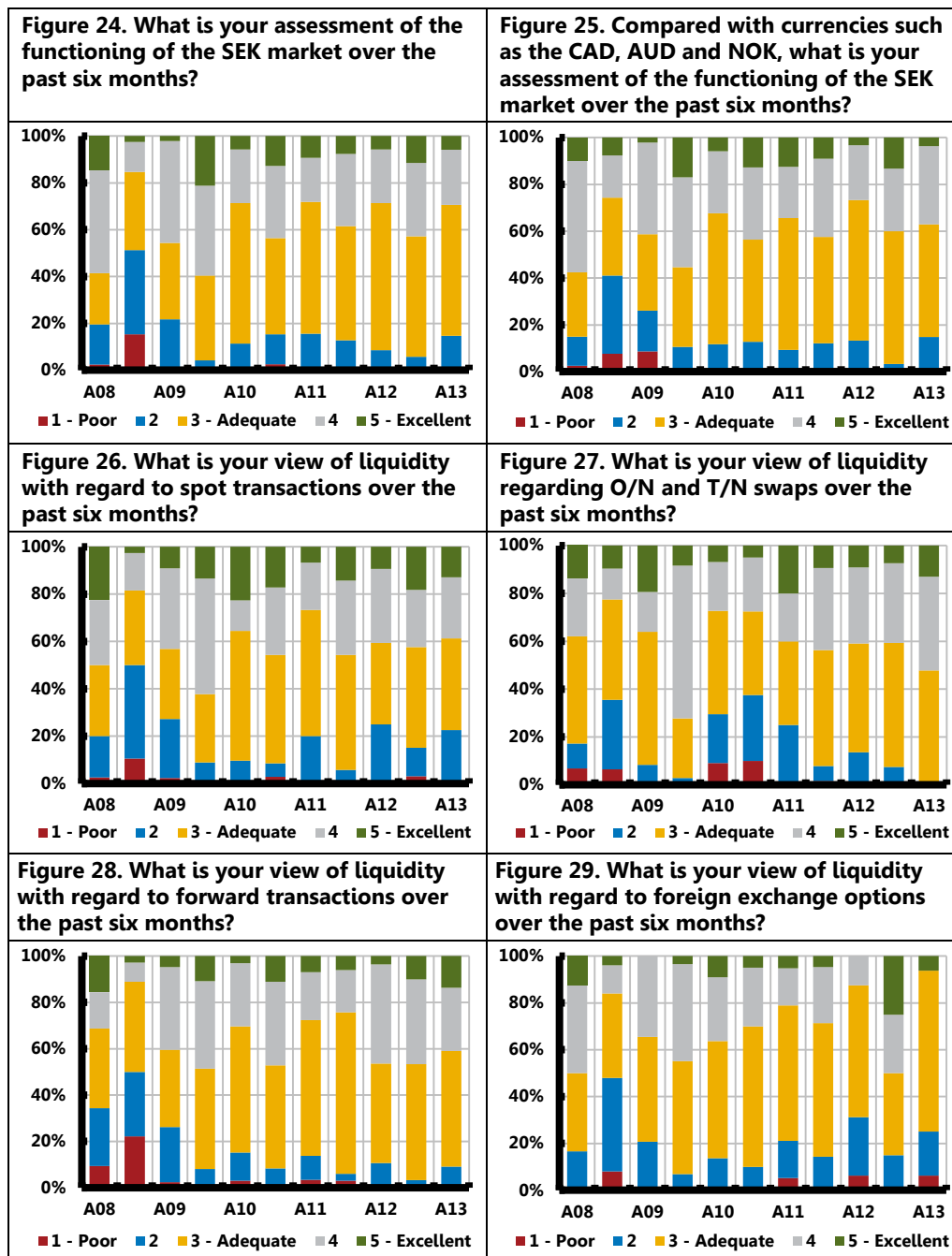
²⁰ STINA stands for STIBOR T/N Average. A STINA contract is an agreement lasting up to a maximum of one year to pay or receive the difference between an agreed fixed rate of interest and a variable overnight rate (STIBOR T/N).

²¹ 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 IN THE INSTRUMENTS ON THE SWEDISH FOREIGN EXCHANGE MARKET²²



²² 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.

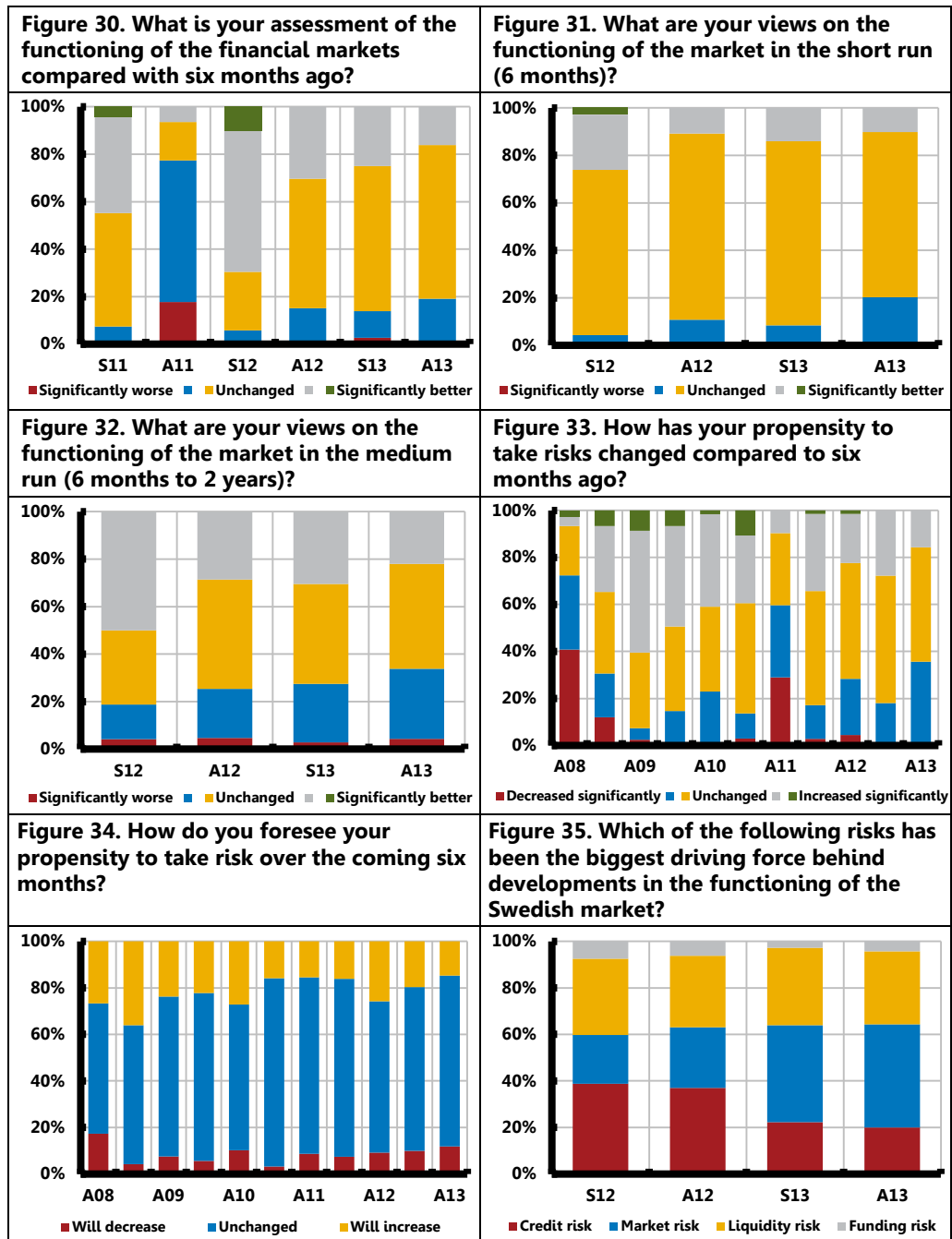




Diagram 36. The respondents' assessment of how the selected risks in Chart 2 have developed over the past six months

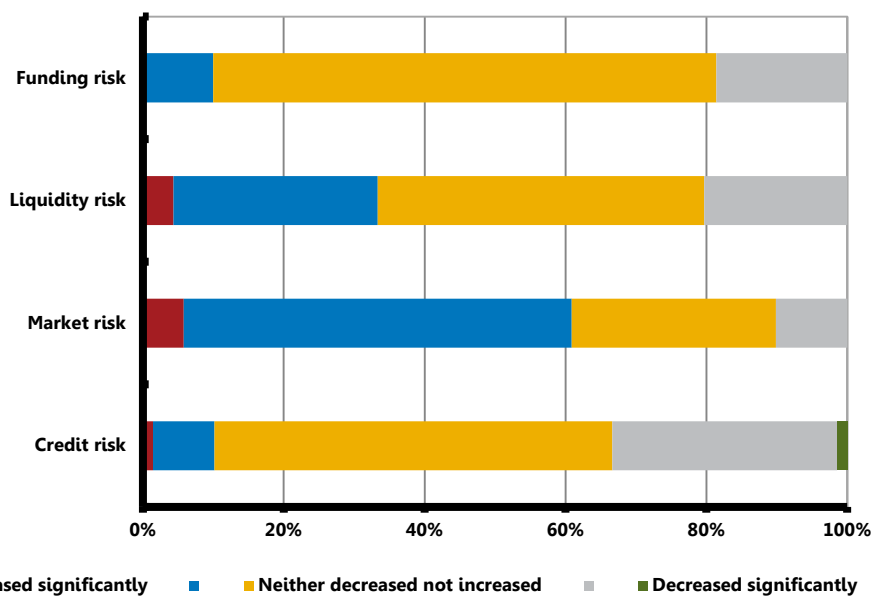
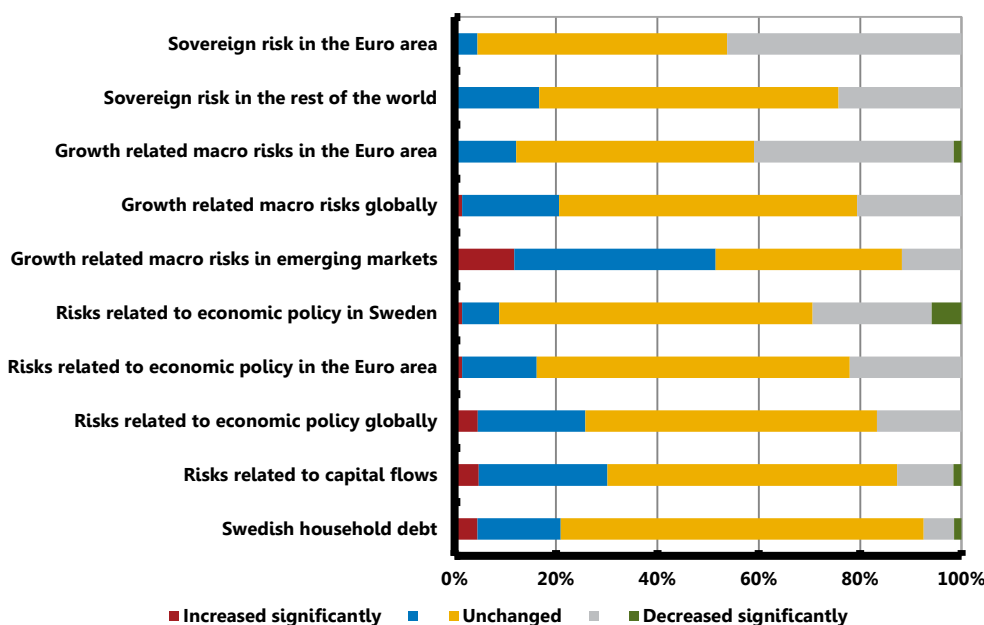


Diagram 37. The respondents' assessment of how the probability of the selected risk factors in Table 1 has changed since the previous risk survey





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 regulations have 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 coming regulations to affect the functioning of the Swedish financial market? What regulations are you referring to?
- In what way do you expect coming regulations to affect your business? What regulations are you referring to?
- What is your assessment of the change in propensity, possibilities and mandates to take on risk for market makers in the Swedish money and bond market during the past six months? Has the development had any consequences for the functioning of the markets?
- Which factors do you consider have had the greatest impact on the Swedish market makers' propensity and opportunity to take on risk?
- How do you perceive that the interest in issuing or investing in corporate bonds has changed over the past six months? What factors have affected this interest?