PRESS RELEASE

DATE 5 September 2007
NO. 34
CONTACT Press Service, tel. +46-8-787 0200

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

Global turbulence and the Swedish fixed income market

Deputy Governor Lars Nyberg gave a speech today at a fixed income seminar in Stockholm organised by OMX. In his speech Mr Nyberg discussed the structure of the Swedish fixed income market. He also reflected on the current unrest in the international financial markets and discussed why we have not seen the same development in Sweden.

Detailed regulation of fixed income market not necessary

"Sweden currently has a smoothly functioning money market. Large volumes can be sold at low cost. However, this was not always the case. We have had unfavourable experiences of government intervention in the fixed income market. Forty years of regulation, which it took most of the 1980s to phase out, led to inefficiency, stagnation and a lack of competition. When the central government introduced a securities transaction tax in 1987 it led to trade in Sweden coming to a halt and being conducted from London instead," began Mr Nyberg.

"There are thus good reasons to think twice before trying to regulate the market. Government intervention should only come into question when problems arise that the market is unable to manage itself, for instance consumer protection. However, the fixed income market is still predominantly a market for professional investors and there is little need to protect consumers trading directly on the market."

The international market: Where is the real credit risk?

"At a seminar like this it is interesting to also reflect on the current unrest in the international financial markets. In recent years, many banks have by various means sold parts of their credit risk to other institutions. Investment banks have packaged loans in special portfolios or companies and then financed these by issuing bonds on the fixed income market. The market for various forms of CDO (Collateralised Debt Obligations) has grown rapidly and large loan volumes have moved out of the banks to other financial agents. This has been a positive

SVERIGES RIKSBANK

development in cases where credit risk has been transferred to investors with large equity capital, such as insurance companies and pension funds. It has improved market stability, that is, the market's resilience to unexpected shocks. But the problem has been that no one has been really sure where the credit risks have ultimately gone. The new instrument for parcelling up and then dividing credit risk into different tranches and selling them on various sub-markets has made it difficult to gain a picture of which balance sheets the risks actually come onto."

"In recent weeks we have seen that the credit risks have not been reaching the investors with the capital to bear them to the extent expected. They had sort of got stuck halfway, in specially created financial companies (SIVs, Conduits and so on) which were not as well capitalised as the banks or the insurance companies and which had largely acquired money on the short-term money market. This has largely occurred through ABCPs (Asset Backed Commercial Papers), which have used the underlying assets in the loan portfolios as collateral. It is not only traditional bank loans have been financed in this way, but also covered bonds and specially packaged loans to risk capital companies," said Mr Nyberg.

"The transfer of credit risk from the banks' balance sheets is based on the market being willing to refinance the companies to which the credit risk has been transferred. As long as the market functions efficiently, this refinancing also functions well. But many banks have guaranteed the short-term financing of the CP market through promises of loans or in other ways. The credit risks have thus in reality largely remained in the banks."

"In August uncertainty over developments in the US sub-prime market intensified, which made investors doubt the creditworthiness of a number of assets (and the solvency of the companies to which they had been transferred, one assumes). At the same time, uncertainty arose in the market regarding which agents were exposed to these assets. This all resulted in investors no longer wishing to buy CPs when the old ones matured, and the banks were therefore forced to honour their guarantees and take back the credit risk they had sold. Large volumes were transferred to the banks in just a few days, larger than many banks could manage. This resulted in liquidity problems in the market. In this situation both the ECB and the US Federal Reserve chose to intervene," continued Mr Nyberg.

"When the banks were unwilling, or unable, to assist with funding, the financial companies were quite simply forced to try to quickly sell off the assets that could be sold. This led, for instance, to considerable pressure in the covered bond market, where market makers actually ceased pricing during a brief period.

Credit risk moved quickly and in large volumes

"At present it is too early to say anything about where the developments in the international fixed income market might lead. The fundamental problem is that poor quality credits have found their way into the banks' balance sheets and outside of them, and it is likely that not all of them have come to light yet. Assessing bad loans takes time; we Swedes are well aware of this from our bank crisis. It is scarcely any easier to assess instruments based on bad loans. But the fact that there are bad loans hardly comes as a surprise; many have been aware of the weaknesses in the sub-prime market. The unexpected element was the speed and extent to which the loans poured back from the market to the banks,

SVERIGES RIKSBANK

when the CP market suffered problems. This is what comprises a liquidity or "funding" crisis. The lesson is clear; the leverage was higher than the market could take."

"I believe that we will see at least two clear effects of recent events in the market. Firstly, that the price of risk will not return to the earlier low levels. The liquidity premium will in all likelihood also be higher than before, at least for the time being. It would be surprising if investors were to continue financing high-leverage loan portfolios as willingly and cheaply as before. It would also be surprising if the banks continued to expose themselves to the liquidity risks latent in the constructions made to reduce the credit risk in their balance sheets."

"Secondly, the requirements for insight into the market will probably increase. It is unacceptable from both the shareholders' and the supervisory authority's point of view not to be able to see the actual credit risks inside and outside the banks' balance sheets. We may not have seen the end of the leverage game, but we have at least taken one step in that direction," said Mr Nyberg.

Calm in Sweden

"Should we expect the unrest on the international fixed income markets to spread to Sweden? I do not think there is much risk of this. One important reason is that the Swedish banks have not to any significant extent transferred the loans out of the balance sheets. This means that they do not run the risk of large volumes returning to them in the same way as many banks in other countries. Nor do the Swedish banks have any major exposure to the US sub-prime market. In addition, there are no companies financing large loan portfolios in the short-term money market in Sweden – in actual fact there is no market for commercial papers."

"But of course Sweden is not isolated from the rest of the world. Both the banks and the Riksbank consider it important to closely follow further developments. The way in which a higher price for risk might affect the Swedish economy is one of the subjects we will have reason to discuss when the Executive Board of the Riksbank meets tomorrow for the first monetary policy meeting of the autumn," concluded Mr Nyberg.