

Speech

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The Riksbank's counterparty system

Speech in connection with the Riksbank's annual
Primary Dealers dinner

Hello and welcome to the Riksbank's annual Primary Dealers dinner. This year is a bit special, as our monetary policy counterparty system is celebrating the tenth anniversary of its launch. It is also a special occasion for me personally, as I was one of the shipworkers involved in building the PD boat. Ten years may not seem much to get excited about, but one should remember that this particular ten-year period has been a very eventful period on the financial markets. We who have gathered here today are also living proof that a lot has happened since 1991. Well, I don't mean us personally, that we look ten years older, I was thinking of the PD circle. During the first half of the 1990s we had signed contracts with 14 institutes which thus became monetary policy counterparts. Today we have seven. On the currency side the development has been in the opposite direction.

A different world

Today the Swedish finance markets are open to the outside world, which we have experienced in particular with regard to the development of the krona and the Ericsson share in recent times. Our monetary policy PD system was born into a different world. Then, the exchange rate was fixed, the last elements of currency regulation had been removed relatively recently, the deregulation of the domestic market had just celebrated its fifth birthday and the negative effects of the securities transaction tax were still fresh in our memories. At the beginning of the market based monetary policy era, the Riksbank had the same counterparties as the Swedish National Debt Office had in its authorised dealer system. This perhaps

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wasn't so strange, as the division between monetary policy and management of the national debt was not as clear then as it is now.

Given the changes that had taken place, it seemed important to us at the Riksbank to help develop, together with the market players, the market's way of functioning. We therefore began to work out our own monetary policy counterparty system. Of course, this was in our own interests, as effective markets are a necessary condition for ensuring that the channels by which monetary policy affects the economy will function in a desirable manner. Moreover, better functioning financial markets would contribute to increasing economic growth by connecting depositors and borrowers in a more effective way.

Risk management was a clear example of how we could contribute to strengthening the functioning of the markets. The securities transaction tax that I mentioned earlier had had a very negative effect on spot and derivative trading in Swedish securities and thus made risk management more difficult. A clearer market-maker system facilitated risk management. Another example of how the Riksbank contributed to the market's efficiency was that we put part of our portfolio at the disposal for repos to develop the repo market.

We used the systems in the USA and UK as the models for our regulations, which also made its mark on the naming of the system. Primary Dealer may not fully reflect the role played by you, the counterparties, in Sweden, but we could not think of a better Swedish name. Authorised dealers had long been the name used for the National Debt Office's counterparties.

Clearer rules of the game

With our own counterparty system we also gained an opportunity to create clearer rules of the game for the operations. Up to the end of June 1991 we implemented our monetary policy market operations via the Swedish National Debt Office's authorised dealers, as already mentioned. The fact that this was a fairly loose connection was evidenced by the fact that the only written agreement confirming the relationship was a paragraph in the agreement between the Debt Office and the dealer. This said that the Riksbank would in principle implement its market operations with the Debt Office's authorised dealers. That was all. The lack of clear requirements stating what was expected of the counterparties, or for that matter of the Riksbank, provided some problems. Some counterparties, for instance, were very modest in their actions on the market and stepped down as soon as there was a bit of headwind. Naturally, this wasn't good for either the other market participants or the Riksbank. Furthermore, the Debt Office's authorised dealer circle was chosen on the basis of national debt policy interests, which basically involved having a large primary market. It was more important for monetary policy that the counterparties were important players on the secondary market. We therefore also came to place partially different demands on the institutes than those in the authorised dealer agreements when our primary dealer agreement was presented at the end of June 1991.

According to this agreement, the counterparty should be active in the Riksbank's market operations and make bids on the repos, set market prices on treasury bills

and treasury bonds in the secondary market and pursue broad operations in general. In this way, we wanted to contribute to the existence of a priced yield curve. We also supported the Swedish National Debt Office's work on concentrating issues to benchmark bonds. The requirement for broad operations was added as we realised that this was a necessary condition for the Riksbank's market operations to obtain a rapid and widespread impact on the money market. As a result of the important role played by the market for mortgage bonds, we also required that the counterparties should be active in setting market prices on trade in some of the mortgage institutes' bonds. In addition, we wanted the counterparties to be dealers for the Debt Office.

In order to build up stability and confidence in the Swedish finance market, we had demands as to how the counterparties should act. The way this was expressed in the agreement was to state that trade should be carried out in a stable, secure and confidence-building manner. There should be good systems for assessment, follow-up and control of the risks connected with trade in interest-bearing securities. The counterparties should also have a documented policy for their operations and the risks taken. They should also provide statistics on their turnover.

A clearly regulated relationship also aimed at facilitating any discussion of problems and shortcomings in the relationship between the Riksbank and its counterparties, where necessary. It should also make it easier for us to obtain information on any important changes on the financial markets. And this is an important input into our monetary policy decision making. It was thus expected that the counterparties would provide regular information and maintain a constructive dialogue with us on important development trends on the market. We would meet at least once a year to exchange views and discuss any problems in a more systematic manner.

A couple of years after the introduction of the PD system on the interest rate side, a similar system was introduced on the currency side, which was already covered by a relatively well-functioning market guarantee system. The requirements in and motives behind the agreement on the currency side are largely the same as those on the monetary policy side.

Changes in the counterparty circle

The content of the agreement we formulated at the beginning of the 1990s is in principle the same today as it was ten years ago. In 1998 we removed the requirement of being one of the Debt Office's authorised dealers and setting two-way prices on treasury papers and mortgage bonds. The latter requirement was replaced by a turnover requirement, which involves the counterparties contributing to good liquidity on the secondary market. In addition, we introduced the requirement that the counterparty should be under the supervision of a financial supervisory authority. However, despite these changes, the main agreement structure still stands. At the same time, a lot has happened in the financial markets that has affected the counterparty circle. Here, I am mainly thinking of the factors that led to a reduction in the number of counterparties on the interest rate side,

i.e. the internationalisation of the economy, the reduced profitability in trading, the changes in economic policy and the increased consideration of the risks.

The greater competitive pressure that followed on from the economic internationalisation has led to a wave of mergers, where SEB and Swedbank are only the most recent example. This has led to our counterparties becoming fewer, but larger.

The increased competitive pressure has also contributed towards putting pressure on profitability in Swedish interest rate trading, a development that has received considerable assistance from the changes in economic policy. In 1993 a new monetary policy regime was introduced, which is aimed at price stability with an inflation target, and a couple of years later began the consolidation of the central government finances. Thanks to this changeover in policy, Sweden is no longer a high yield country. We can also see how inflation expectations are now relatively strongly anchored around the inflation target. The reduced profitability and increased stability on the Swedish interest rate market has probably contributed to the change in direction of trading and the decline in more speculative deals. Moreover, events such as the falls of Barings Bank and LTCM, as well as our own bank crisis, have led to more stringent risk management and reduced risk mandates. The gold rush days have been replaced by more normal times.

In the context of risk management, the unsuccessful attempt to introduce an interest future for Swedish treasury bonds is often mentioned. When this was introduced in 1998, the market-maker requirement disappeared from the Debt Office's authorised dealer agreement. The Riksbank had already removed this requirement from its counterparty agreement in order to attract more players to the Swedish interest rate market. The introduction of the future was an attempt to increase the power of attraction of the Swedish market. It was not a bad idea, as the future would have meant an adaptation to the systems that are used in the larger international markets. However, we all know what happened. After the failed attempt the market-maker system was not recreated, which made the institutes' risk management more difficult. This function has been partly replaced by a greater element of broker trading. In this perspective it will be exciting to see what the introduction of OM's new electronic platform for interest rate trading will mean for the Swedish market.

Conclusion

I would like to say a few words in conclusion on the trends I believe will affect the Swedish interest rate market in future. I have already touched on the internationalisation of the economy. This will, of course, continue with increasing competition, both between market participants and between different market places. The introduction of the euro will hasten this structural change further. Even now, two years after the start of EMU, there have been major changes on the money and bond markets in the euro area. In particular, we have seen a rapid growth in corporate bonds. It is clear that borrowing in the securities markets in the euro area has increased and that the similarities with the USA have become greater, but differing national regulations still comprise a major obstacle. However,

the realisation of the EU's action plan for financial services and the Lamfalussy Committee's proposals will gradually demolish these obstacles. Sweden is of course affected by this development, although we have chosen to remain outside of the monetary union for now. If we are to retain a functioning bond trade within Sweden, we will probably need further improvements in the efficiency of the market place.

Like most of the other countries in the EU, Sweden has worked hard to consolidate its central government finances. If this trend continues, and the national debt is reduced, the supply of treasury papers will decline. There are many who hope that this empty space will be filled by corporate and mortgage bonds in the way that appears to be happening in the euro countries. A glance at the history book also shows that this would be fully possible. At the end of the 1980s Sweden was one of the best markets in the world for such bonds. We could very well see a renaissance, but this is far from certain. The introduction of the euro has given us a tough competitor. The small size of the Swedish market has meant that large volumes of corporate bonds have been issued on the euro market instead. It is probable that the local knowledge will continue to be a competitive advantage for Swedish players, but the size of the krona market means that there is great uncertainty as to what an increased element of private borrowing in the markets will mean to interest rate trading.

In the slightly longer term, it is probably technological developments that have the greatest significance for the development of interest rate trading. Electronic platforms have had a major impact internationally. On the currency side, platforms like EBS are already dominating trading and on the interest rate side the corresponding system is being built up on a large scale. In Europe, for instance, we have EuroMTS. Sweden appears to be slightly behind the developments on the larger markets.

When we created our current counterparty system, we looked at how trading and market places were designed in countries with markets that functioned well. This method is just as valid today. It is towards this type of market, where there are both interest rate futures and electronic platforms, that we should turn our eyes when considering how we want the markets in Sweden to function. Therefore the electronic platform being launched by OM on 15 May is of great interest. It is possible that the requirements made for participating in trading will comprise an unnecessarily large barrier, but this could change gradually and the system could become more open. At the same time, one should remember that there is scarcely any one individual trading system that is best for all, as different players have different interests.

Given the changes in the financial markets that have been driven inexorably forward by internationalisation, the EMU, the consolidation of the government finances and the rapid developments in technology, there is every reason to review our counterparty system and the content of the PD agreements on a regular basis to ensure that they meet the requirements of the outside world.

Thank you for listening!