

Lars Heikensten: Challenges for the Swedish fixed income market

Speech by Mr Lars Heikensten, First Deputy Governor of the Sveriges Riksbank, at the RöntEvent, Modern Museum, Stockholm, 8 May 2001.

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The Swedish fixed income market has undergone a fantastic development over the past 20 years. This refers to both the volumes traded and the level of sophistication. However, the journey here has by no means been a simple one. At times, both profitability and activity have been quite low. Today the market is facing new challenges. Profitability appears to have fallen and with it both the number of players and the volumes traded. The risks are now also covered to a greater extent by Swedish players trading in, for instance, the German market. The Swedish fixed income market has thus lost ground, relative to other countries. It also appears to have lagged behind in the sense of technology. A year or so ago there was an attempt to introduce a new instrument, a Swedish fixed income future, with the aim of increasing the market's powers of attraction. This attempt did not live up to expectations, however. Today we are gathered here partly because of a new initiative, a platform for electronic fixed income trading.

Let me start by saying a few words about the way I see the role of the Riksbank in this context. Our fundamental objectives are to safeguard price stability and promote a safe and efficient payment system. There are connections to the fixed income market in both of these considerations. However, this does not mean that we have an opinion on which system solutions the market chooses as long as they fulfil reasonable requirements for security and efficiency. This area lies outside of our core objectives. This is why we also remained outside of the discussion on a fixed income future a few years ago.

Given this, I would like to share a few, brief reflections with you. Firstly, I shall go through the advantages of electronic trading. My views on this are mainly a matter of principle. After that I intend to make some brief comments on a few aspects of the Swedish fixed income market today and in this context say a few words on the consequences that electronic trading may entail. Finally, I intend to take up a more specific question, settlement on the fixed income market. We do not consider that this functions sufficiently well from a financial stability perspective.

Electronic trading, an opportunity

Let me begin by pointing out that electronic trading systems are being used to an increasing extent around the world. It seems reasonable to assume that this means they have clear advantages, otherwise private players would not invest in them. However, a public authority naturally also wonders whether they involve some kind of risk. With this in mind, there has been a study on electronic trading systems made within the framework of the G10 central bank co-operation.¹

The report emphasises a number of advantages:

- Electronic trading systems make it possible to manage large amounts of trading-related information. This enables all trading-related processes in the financial companies to be integrated, which in turn provides opportunities for linking together the entire transaction chain (business contracts, confirmation, clearing and settlement). This is known as straight-through-processing (STP).
- Electronic trading also enables a greater insight into the market. This can in turn make it possible to reduce any information asymmetries between different players. That is, of course, a disadvantage for those who have previously profited from the imbalances, but normally benefits the system as a whole.

¹ Bank for International Settlements, [2001], "The implications of electronic trading in financial markets". Report by a working group established by the Committee on the Global Financial System of the central banks of the Group of Ten countries.

- Another important aspect is that electronic trading enables anonymity during trading. This often has a positive effect on the markets' method of functioning and thus their efficiency. For instance, it can facilitate settlements of large positions.
- The opportunities for access to the market can also be improved, if desired. This applies both from a geographical perspective and for different types of players. An opportunity is thereby given to influence the structure of the market in that more players with different needs can be active in many different markets. This can lead to improved liquidity and greater competition. According to the report, it could in the long term lead to a change becoming necessary in the traditional role of the intermediaries. For example, they may choose to concentrate on the segments they consider most profitable.
- A further important effect is that price formation can be improved when all trading is centralised to one platform. This could make it easier for market players to find a balanced price. New information will have a rapid impact on prices with the aid of the new technology. This can in turn lead to a reduction in interest-rate differentials or spreads between purchase prices and selling prices.

At the same time, the report points out the risks ensuing from electronic trading systems. One evident risk, which may seem trivial in a way, but in reality may have great significance, concerns the technology itself. It quite simply has to work, and do so even in situations where there is unrest on the market. Knowledge of the traditional methods of trading, such as telephone trading, will of course also decline over time. This means it will probably become increasingly difficult to trade using alternative methods in the event of system disturbances. Allow me therefore to emphasise the importance of the systems being reliable and of having functional emergency routines.

Electronic trading systems will not necessarily lead to all of the benefits I recently mentioned. On the contrary, they could be used by the owners, who in many cases are part or all of the market collective to begin with, in order to gather exclusive and valuable information on, for instance, market behaviour. Given this, it is hardly surprising that ownership issues are often the most important in this context.

A further problem - and I shall return to this in a little more detail later - is that the increased anonymity in trading - which entails certain advantages - can also have the disadvantage that it becomes more difficult for the players involved to check their counterparty risks.

The Swedish market today

I mentioned at the beginning some of the problems today on the Swedish fixed income market. These are partly connected with the radical fall in the national debt. During the 1990s, the national debt increased by an average of SEK 80 billion on an annual basis. Only a few years ago, namely in 1997, this debt amounted to SEK 1,420 billion, or almost 80 per cent of GDP. This should be compared with today's level of SEK 1,280 billion, or approximately 60 per cent of GDP. According to the Ministry of Finance, the national debt will have been reduced by a further SEK 140 billion in 2004. The successful budget consolidation process has thus cut down on business opportunities in that the volumes have been reduced. However, the main thing is that the market has become more stable with fewer interest rate fluctuations.

The Riksbank has also contributed to the stability by being involved in establishing a credible regime with a low inflation rate. We have also endeavoured to make our monetary policy open and provide clear signals, with the aim of reducing unnecessary fluctuations on the market.

At the same time, it is important to remember that the increasingly improved central government finances are essentially a very good development from a national economy point of view. Not even this market, which has made a good living from central government financial problems, should be concerned over this. The falling volumes of treasury papers entail new opportunities for other borrowers. "Crowding out" will now be replaced by "crowding in". This should open the way for increased corporate financing with bonds, an area where we have a good tradition. Furthermore, an increase in construction should create a greater financing need. It should also be possible to expand the part of the fixed income market that is aimed at households. The fact that the share market does not merely rain blessings has been made quite clear from developments over the past year. A clear and practical system for bonds aimed at households could be one good alternative to both shareholding and interest funds.

It is scarcely surprising that the Swedish market is markedly different from, for instance, the Treasury market in the USA or the Bund market in Europe. The number of players is much smaller, while the depth of the market is less. This reasonably entails the costs of doing business of the same size being higher and the relationships between players being closer. This carries a risk, particularly in times of uncertainty, of affecting the functioning of the market. The inclination to take on risks then declines and with few players and problems with trading situations, the market has occasionally almost come to a standstill.

As you know, there are differing opinions as to whether this type of problem can be solved or alleviated with the aid of electronic trading. I do not intend to become involved in that discussion. Part of the positive effects of electronic trading that I mentioned earlier on a more general level will probably be smaller in a market like the Swedish one than on a larger market. Of course, even in terms of direct operating costs, the savings will be less when calculated in kronor.

At the same time, it is clear that electronic trading will involve new opportunities. Above all, we hope that it will bring about an increased interest from both Swedish and foreign players in being active and doing business on the Swedish market. How this turns out will undoubtedly depend on the actions of those in the system from the start. If they choose to limit entry or make it more difficult for new players, there is a risk that the socioeconomic gains with the new platform will not be very great.

Settlement is important

Allow me to conclude with a few words on business settlement. This is a question that in itself does not concern the choice of whether or not we should have electronic trading. All business is settled, whether this is done through a traditional market-maker system or by electronic trading. Those buying fixed income instruments want to be sure of receiving what they have bought and those selling want to receive the money they have been promised, regardless of the trading form. On the other hand, it is clear that it would be desirable to take the opportunity to design a new system that would provide a good means of handling settlements. This is particularly important as the increased volumes hoped for, which are the whole point of the new system, will create increased risks in terms of settlement.

Today settlement on the fixed income market is done by means of net settlement in VPC. This works well in many ways and the routines are perceived as manageable by the market players, as far as I understand it. However, the system is nevertheless obsolete and involves risks. If one of the parties involved failed to meet its payments during the daily settlement, for instance, if one party was forced to make a suspension of payments or simply lacked sufficient liquidity, the situation could become troublesome. The existing routines can be called into question. One can imagine situations where settlement is not achieved, which could have consequences for the liquidity of the banking system. From the point of view of financial stability, this is an unsatisfactory situation.

The requirement normally made of a settlement system is that settlement can be achieved even if the largest party should fail. This requirement is not met in Sweden and the security in the Swedish payment system would not be regarded as satisfactory in an international evaluation.

VPC's owners, i.e. the banks, undertook to remedy this problem when they purchased VPC from the government. That was in spring 1999, and as far as I know nothing has yet been done.

Common to all methods, unfortunately, is that they cost a lot of money to implement and this money has to come from the market players in some way. However, it should be in the interests of the market players that something is done. In the long run, it is unlikely that the banks' international counterparties will accept that settlement in Sweden is done through systems that are inferior to those in the rest of Europe, and with questionable security. It is reasonable that we should live up to the international standards now being established. It would be a defeat for the market if the government had to enforce solutions in this field through legislation.

Starting point for a renaissance

These brief comments show that there are challenges awaiting those who work on the Swedish fixed income market. Although the electronic platform being launched today will not be able to meet all of these, I still hope that it will prove to be the starting point for something new and contribute to an eagerly-awaited renaissance for Swedish fixed income trading.

Good luck!