S U M M A R Y

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Government bond market – the need for regulation and supervision

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Summary

This report discusses Finansinspektionen's view on the need for regulation and supervision in the government bond market. FI's level of ambition in the supervision of the fixed income market has long been lower than that of its supervision of the stock market. The reasons for this are primarily historical and no well-documented analysis exists. The need for such an analysis has arisen as the supervision of financial markets has developed in Europe. In conjunction with the introduction of MiFID (the EC Markets in Financial Instruments Directive) the need for regulation and supervision in the fixed income market has been discussed at European level.

In our analysis we have focused on the market for government securities and the government bond market as the largest and most highly developed sector of the fixed income market in Sweden. This makes the analysis more efficient, allowing it to form the basis of further discussions regarding other sectors of the fixed income market.

The report is based on a discussion paper published by FI on 22 January 2007, which is the first part of the report. The views of market participants on the discussion paper are summarised in the second part of the report. The third part of the report contains FI's deliberations and findings.

The fixed income market and stock market differ in several respects. One of the most fundamental differences is the structure of the market. The stock market is principally an order-driven exchange. The fixed income market is based on market maker trading, in which a number of intermediaries (mainly banks) quote prices and, in most cases, buy and sell bonds on their own account. The differences in the trading structure and other circumstances as well, have meant that the investors consist primarily of institutional investors and large companies. In the stock market the circle of investors is wider and also includes private individuals.

In the government bond market there is only one issuer. Government bonds are issued through the Swedish National Debt Office and the intermediaries act as distributors.

A need for regulation and supervision in a market arises from a market failure or a problem that the market has not been able to cope with and that has resulted in economic costs. FI does not consider that there has been a clear market failure that could be resolved by regulation and supervision of the government bond market.

Many of the rules for securities markets, including MiFID, have been adapted to the conditions of the stock market and exchange trading. In many ways it is difficult to apply the same rules to a market based on market makers. Some examples of this are transparency and best execution which are regulated in MiFID.

The Swedish fixed income market functions relatively well. Many market participants bring up the issue of whether competition is working as well as it should, given the low number of market makers. Any further reduction would have a negative impact on competition. Many of the problems that exist are rather the result of the structure of the market than of inadequate regulation and supervision.

A change in market structure from market maker trading to exchange trading may improve competition and attract more investors, above all foreign and small investors. This may have a positive impact on price formation and market liquidity. On the other hand, the depth of the market – the market's ability to absorb large orders without affecting the price – is probably greater with market maker trading. It is very much an open question whether a change in market structure is desirable. We do not see sufficient reason to put forward an opinion. FI's role is primarily to carry out suitable supervision under the existing market structure. The Swedish National Debt Office and market participants have good reason to advocate a change to the structure, were this to improve the operation of the market.

One component of a possible change to the market structure, which is not necessarily dependent on whether exchange trading or market maker trading is preferable, is central counterparty clearing. Such a function should mean reduced barriers of entrance for new actors. Central counterparty clearing is presumably also a condition for a well-functioning exchange trading.

The management of *conflicts of interest* is regulated in the MiFID. The major banks which are market makers have institutional investors (for example investment funds and insurance companies) within the group. Furthermore, the banks also act as advisors and asset managers to other parties. The management of conflicts of interest within banking groups probably has significance to the fixed income market. FI has established that there are different types of conflict of interest. Some of these may be acceptable; for instance when market makers' information, in the form of knowledge of their own order flows, affects the price they set in the market. Utilisation of this information can hardly be viewed as improper. On the other hand, there can be other conflicts of interest where there is reason to impose clear requirements on their management. It is important how market participants evaluate conflicts of interest and how they are managed. FI will therefore address the management of conflicts of interest in a separate study.