

# Daiwa's View

## Is inversion of LIBOR-OIS new normal?

- Risk of asset swap transactions may have changed fundamentally

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Daiwa Securities Co. Ltd.

### Risk of asset swap transactions may have changed fundamentally

### Is inversion of LIBOR-OIS new normal?

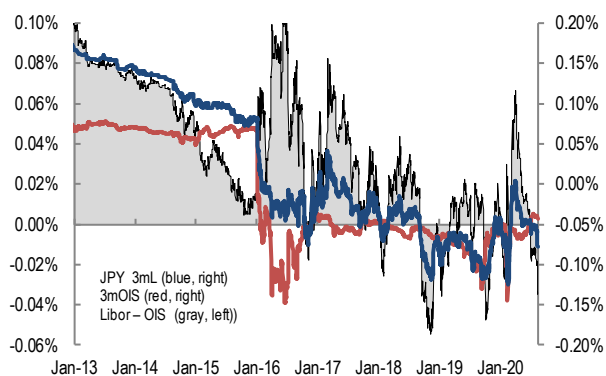
Thus far, it was thought common sense that “the LIBOR is higher than the OIS (Overnight Index Swap), which is a forecast for a policy interest rate in the future” in the financial market. This is because credit risk at financial institutions is included in the LIBOR as a term.

However, recent data observed in the Japanese and European markets defies this logic. Currently, the 3-month JPY LIBOR-OIS spread and EUR LIBOR-OIS spread stand at  $-0.03\%$  and  $-0.01\%$ , respectively, taking root in negative territory. The inversion has newly occurred in not only Japan but also Europe, making us feel the possibility that this inverted phenomenon will become the new normal going forward.

Why has the LIBOR-OIS spread been negative in Japan and Europe? Of course, it is not to say that creditworthiness of Japanese and European financial institutions has exceeded that of nations. Probably, the actual condition is opposite. One factor behind this inverted phenomenon is weaker operational capacity at Japanese and European financial institutions, in our view.

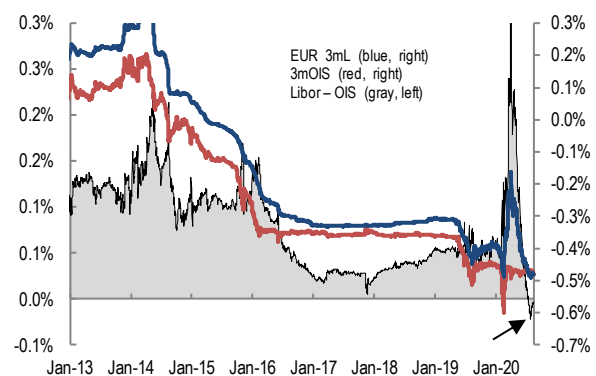
Weaker operational capacity at financial institutions, caused by the negative interest rate policy and prolonged monetary easing, has become a constraint in terms of the continuation of monetary easing. Central banks in Japan and Europe are thus now providing funds to financial institutions at advantageous terms. For example, the ECB supplies money to financial institutions at  $-1\%$  if conditions are met (current deposit facility rate  $[-0.5\%]$   $-0.5\%$ ). The BOJ is also applying  $+0.1\%$  IOER to current accounts' outstanding balances, which correspond to the outstanding loans provided through the special loan program to cope with the COVID-19 pandemic. These measures have enabled financial institutions to raise funds at more advantageous terms than the OIS.

### 3M JPY LIBOR, OIS



Source: Bloomberg; compiled by Daiwa Securities.

### 3M EUR LIBOR, OIS



Source: Bloomberg; compiled by Daiwa Securities.

Of course, these powerful fund-provision measures are temporary to address the pandemic. It is thus highly likely that they will be terminated in line with the end of the pandemic. Therefore, the current situation where fundraising terms at financial institutions are outstripping the OIS may come to an end with the pandemic.

However, if preferential fundraising measures for financial institutions in Japan and Europe are taken to address the reversal rate (side effects of monetary easing), rather than the pandemic, we cannot ignore the inversion as a transient phenomenon caused by the COVID-19 crisis.

As [the reversal rate](#) edges up over time, the side effects of monetary easing at financial institutions act like a body blow. It is highly likely that monetary easing will continue over the long term, and therefore the side effects at financial institutions are likely to accumulate going forward. If new crises occur in the future and financial institutions face stronger stress, the authorities could again consider fund provision at negative interest rates below the OIS. If so, the inversion of LIBOR-OIS may take root as the new normal in the Japanese and European market.

This implies that the risk of asset swap transactions (which take advantage of difference between gov't bond yields and swap interest rates) has changed fundamentally. By definition, variable legs of swap transactions are bundles of LIBOR. In the case that the LIBOR is consistently lower than the OIS, the difference between government bond yields and swap interest rates does not return to the previous average value. Strictly speaking, we should use the difference between the LIBOR and the government bond yield's repo rate, instead of the OIS. Either way, with respect to the inversion of government bond yields and swap rates as well, the interpretation would arise that the phenomenon is fundamentally fair in the case that the LIBOR is continuously below the OIS.

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- 2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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### ■ Credit Rating Agencies

#### [Standard & Poor's]

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The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

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#### [Moody's]

##### The Name of the Credit Rating Agencies Group, etc

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The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website ([https://www.moody.com/pages/default\\_ja.aspx](https://www.moody.com/pages/default_ja.aspx)))

##### Assumptions, Significance and Limitations of Credit Ratings

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##### The Name of the Credit Rating Agencies group, etc

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- 2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITs: Daiwa Office Investment Corporation (8976), Daiwa Securities Living Investment Corporation (8986).
- 3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.
- 4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of ¥10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.
- 5) Daiwa Securities Group Inc. and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group Inc. is to acquire up to 5.01% of Credit Saison's total common shares outstanding (excl. treasury shares; as of 31 Jul 2019).
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- In addition to the purchase price of a financial instrument, our company will collect a trading commission\* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements\*\*.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

\* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

\*\* The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

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