Daiwa Securities

Daiwa's View

Is there a liquidity crunch in Switzerland?

- Swiss National Bank is rapidly increasing the size of its draws on Fed swap line

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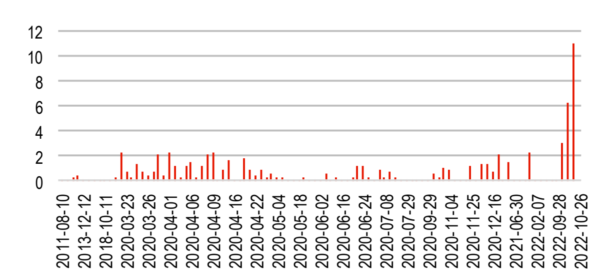
Is there a liquidity crunch in Switzerland?

Swiss National Bank is rapidly increasing the size of its draws on Fed swap line

The Swiss National Bank has been rapidly increasing the size of the draws it has been making on the US dollar swap line it has with the Fed (Chart 1). On 19 October, the draw it made increased to $11.09bn, which was a major change, as the largest draws it made per auction throughout 2020 were around $3.0bn. It is assumed that Fed dollar swap lines are used to relieve liquidity stress. Given the increase in the size of the draws being made, we suspect that liquidity in Switzerland is falling into a critical state. While no draws were made on 26 October, it's still too early to feel relieved at this point. While the increase in the size of draws started on 12 October, there had been signs of tightening in US dollar funding in Switzerland before then. On a USD/CHF basis, the situation has deepened substantially into negative territory since end-September (Chart 2). With the USD/CHF basis becoming more negative than the EUR/USD basis, it is highly likely that Switzerland-specific factors are the cause.

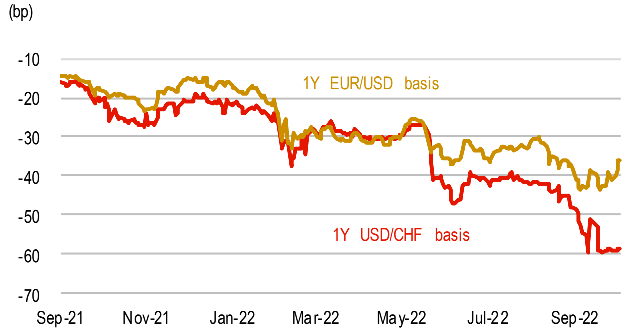
In fact, the end of September corresponds to when CDS premiums at Swiss financial institutions widened rapidly, and market concerns increased about the creditworthiness of corporate credit. There has been a linkage between rapid widening of CDS premiums and the situation becoming more negative on a CHF/USD basis (Chart 3). Moreover, the term structure of CDS premiums at Swiss financial institutions has become inverted in line with the widening of CDS premiums (Chart 4). Usually, the probability of default at the companies in question is projected to be higher in the distant future than in the near future, and, therefore, the CDS premiums become higher the longer the duration. The inversion of the term structure suggests that either (1) the market is factoring in the short-term default risk more than the long-term risk or (2) premiums are becoming higher amid low liquidity due to a decline in the number of market participants trying to take the short–term risk of CDS at the companies in question. It is not yet certain whether Swiss financial institutions are actually falling into a crisis. However, at the very least, the market is concerned about it.

Chart 1: Size of Draws on US Dollar Swap Line by Swiss National Bank



Source: NY Fed, Swiss National Bank; compiled by Daiwa Securities.

Chart 2: USD/CHF Basis, EUR/USD Basis



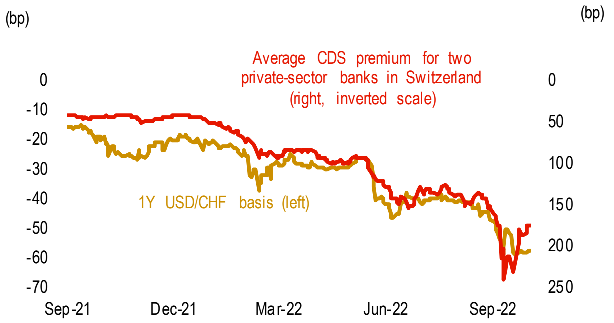
Source: Bloomberg; compiled by Daiwa Securities.

Some appear to argue that the size of draws on the swap line increased because the swap line was utilized in order to conduct arbitrage transactions due to the currency basis becoming more negative, but this is doubtful. The cost of acquiring US dollars via the swap line is set at the US dollar OIS rate + 25bp. Therefore, the cost of acquiring US dollars rises in line with rate hikes in the US. However, if the currency basis becomes more negative than the increased cost of acquiring US dollars, banks can conduct arbitrage transactions by acquiring US dollars at a cheaper cost via the swap line, and then investing them in the currency swap market.

However, if arbitrage transactions are available based on this logic, we should see an increase in the size of draws on the swap line in any nation, not just Switzerland, whose currency basis against the dollar is becoming more negative than the US dollar OIS rate. Although the yen has become increasingly weak against the dollar, the scale of Japan's draws on its swap line has not increased. An increase in the scale of swap line usage has only been observed in Switzerland, which is something that looks unnatural. To begin with, the Fed is likely not in favor of the use of swap lines for the purpose of arbitrage transactions. As mentioned at the beginning of this report, US dollar swap lines were established as a scheme for coping with dollar shortages in the market.

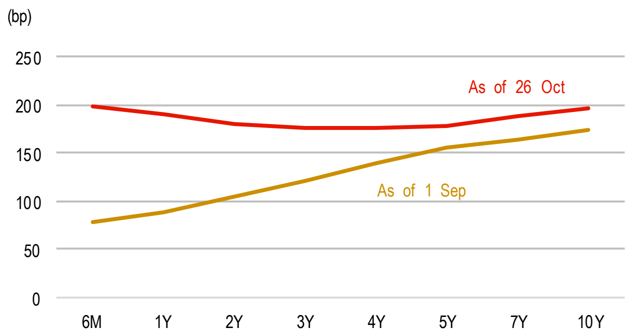
In addition to the question of whether financial conditions at Swiss financial institutions are bad, there is a possibility that some financial institutions have started to face difficulties in securing the US dollar amid global monetary tightening, which is a problem. Global interest rates are rising due to the decline in liquidity. Moreover, we have also started to see other signs that precede an economic crisis.

Chart 3: USD/CHF Basis, Average CDS Premium Among Private-sector Banks in Switzerland



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4: Average Term Structure for Two Private-sector Banks in Switzerland



Source: Bloomberg; compiled by Daiwa Securities.

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