INTERBANK MARKETS

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Banking and Financial Intermediation

INTRODUCTION

- The interbank market is a global network utilized by financial institutions to trade currencies and other currency derivatives directly between themselves.
- While some interbank trading is done by banks on behalf of large customers, most interbank trading is proprietary, meaning that it takes place on behalf of the banks' own accounts.
- Banks use the interbank market to manage their own exchange rate and interest rate risk as well as to take speculative positions based on research.
- Most transactions within the interbank network are for a short duration—anywhere between overnight to six months

UNDERSTANDING THE INTERBANK MARKET

- The interbank market for foreign exchange (forex) serves commercial turnover of currency investments as well as a large amount of speculative, short-term currency trading. The typical maturity term for transactions in the interbank market is overnight or six months.
- The forex interdealer market is characterized by large transaction sizes and tight bid-ask spreads. Currency transactions in the interbank market can either be speculative (initiated with the sole intention of profiting from a currency move) or for the purposes of hedging currency exposure. It may also be proprietary but to a lesser extent customer-driven—by an institution's corporate clients, such as exporters and importers, for example.

SOME HISTORY

- The interbank market in the US started after President Richard Nixon decided to take the country out of the gold standard in 1971.
- From that point currency rates of most of the large developed nations were allowed to float freely.
- The advent of the floating rate system coincided with the emergence of low-cost computer systems that allowed increasingly rapid trading on a global basis.
- Voice brokers over telephone systems matched buyers and sellers in the early days of interbank forex trading but were gradually replaced by computerized systems that could scan large numbers of traders for the best prices.
- Trading systems from Reuters and Bloomberg allow banks to trade billions of dollars at once, with daily trading volume topping $6 trillion on the market's busiest days.

WHO PARTICIPATES?

- Among the largest players are Citicorp and JP Morgan Chase in the United States, Deutsche Bank in Germany, and HSBC in Asia.
- Most spot transactions settle two business days after execution (T+2); the major exception being the U.S. dollar vs. the Canadian dollar, which settles the next day. This means banks must have credit lines with their counterparts in order to trade, even on a spot basis.
- While the interbank market is not regulated—and therefore decentralized—most central banks will collect data from market participants to assess whether there are any economic implications

INTERBANK MARKETS AND LIQUIDITY MANAGEMENT

- Banks are required to hold an adequate amount of liquid assets, such as cash, to manage any potential bank runs by customers. If a bank cannot meet these liquidity requirements, it will borrow money in the interbank market to cover the shortfall.
- Some banks, on the other hand, have excess liquid assets above and beyond the liquidity requirements, and will lend money in the interbank market, receiving interest on such loans.
- Funds are transferred through the purchase and sale of money market instruments—highly liquid short-term debt securities. These instruments are considered cash equivalents since they can be sold in the market easily and at low cost

MONETARY POLICY TRANSMISSION

- Central banks in many economies implement monetary policy by manipulating instruments to achieve a specified value of an operating target. Instruments refer to the variables that central banks directly control; examples include reserve requirements, the interest rate paid on funds borrowed from the central bank, and balance sheet composition.
- US monetary policy implementation involves intervening in the unsecured interbank lending market known as the fed funds market.
- In recent years most monetary policy is conducted via open market operations to control the interest rate in the overnight interbank market.

SOME INTERBANK MARKETS- LONDON

- London – LIBOR : which consists of floating rates based on the London Interbank Offering Rate, is a widely quoted rate on short-term European money market credits. For some time, it has influenced the overseas lending rates of large U.S. banks, particularly when the spread between U.S. money market base rates and LIBOR rates favored the latter.
- The British Bankers' Association (BBA) fixes a value for LIBOR each day at 11:00 a.m. London time for each major currency.
- The daily value of LIBOR is drawn from a panel of contributing banks chosen based upon their reputation, level of activity in the London market, and perceived expertise in the currency concerned. Shortly before 11:00 a.m. each business day, each bank reports the rate at which it could borrow funds of a reasonable market size by accepting interbank offers from banks other than the LIBOR panel of contributing banks. The contributed rates are ranked in order and only the middle two quartiles are averaged in determining LIBOR.

LONDON INTERBANK MARKET

- LIBOR is fixed daily for the following ten currencies: the British pound (GBP), Canadian dollar (CAD), Danish krone (DKK), euro (EUR), U.S. dollar (USD), Australian dollar (AUD), Japanese yen (JPY), New Zealand dollar (NZD), Swedish krona (SKR) and Swiss franc (CHF). There are 15 maturities for which LIBOR is set each day, from an overnight rate all the way up to 12 months. Thus, a total of 150 rates are set each day.[1] These rates are used as reference for about $360 trillion dollars of financial contracts around the world.

LIBOR MANIPULATION

- The LIBOR scandal erupted in June 2012 after the British bank Barclays was investigated by the Financial Conduct Authority.
- Following the investigation Barclays settled for almost $480 million when it was charged by various prosecutors with attempt to manipulate LIBOR rates. Other institutions such as JPMorgan Chase and Citibank were also cited in the event, which quickly grew in amplitude.
- Thus, it appeared that Barclays and other banks acted inappropriately between January 2005 and July 2008 by making U.S. dollar LIBOR and EURIBOR submissions that took into account requests made by its derivative traders and were motivated by profit.
- Rate submissions that took into account the requests of its own business needs or tried to influence the submissions of other banks implied the published LIBOR rates were trying to be manipulated.

THE EURO INTERBANK MARKET

- **Euribor** is short for Euro Interbank Offered Rate. The Euribor rates are based on the average interest rates at which a large panel of European banks borrow funds from one another. There are different maturities, ranging from one week to one year.
- The Euribor rates are considered to be the most important reference rates in the European money market. The interest rates do provide the basis for the price and interest rates of all kinds of financial products like interest rate swaps, interest rate futures, saving accounts and mortgages

CURRENT BANKS SETTING THE EURIBOR

Country	Banks[4]
Belgium	Belfius
France	BNP-Paribas
France	HSBC France
France	Natixis
France	Crédit Agricole
France	Société Générale
Germany	Deutsche Bank
Germany	DZ Bank
Italy	Intesa Sanpaolo
Italy	UniCredit
Luxembourg	Banque et Caisse d'Épargne de l'État
Netherlands	ING Bank
Portugal	Caixa Geral de Depósitos (CGD)
Spain	Banco Bilbao Vizcaya Argentaria
Spain	Banco Santander
Spain	CECABANK
Spain	CaixaBank
UK	Barclays