Breakdown of covered interest parity: Mystery or myth?

Joint work with Alfred Wong

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*The views expressed here are the authors' own and should not be interpreted as those of the Hong Kong Monetary Authority.

Overview

- Recent CIP literature:
  - Counterparty credit risk; funding liquidity risk
  - Dollar shortage; dollar strength; dollar hedging demand
  - Regulatory reforms; balance sheet constraints; limits to arbitrage

  Baba & Packer (2009), Coffey et al (2009), Genberg et al (2009), Hui et al (2011), Ivashina et al (2015), Avdjiev (2016), Borio et al (2016), Shin (2016), Du et al (2017), Sushko et al (2017), Rime et al (2017)

- Derivative pricing literature:
  - Single-curve *versus* multi-curve modelling
  - Risk-adjusted curve for discounting
  - Risk-embedded curves for estimating future cash flows

  Tuckman & Portfirio (2003), Bianchetti (2009), Mercurio (2010), Grbac at al (2015), El Memouni (2015)

- Contribution of this paper:
  - Theoretical explanation for CIP deviation from a swap-pricing perspective
  - No arbitrage in CCBS market
  - Evidence from 7 currency pairs (3 without a dollar leg)

Overview

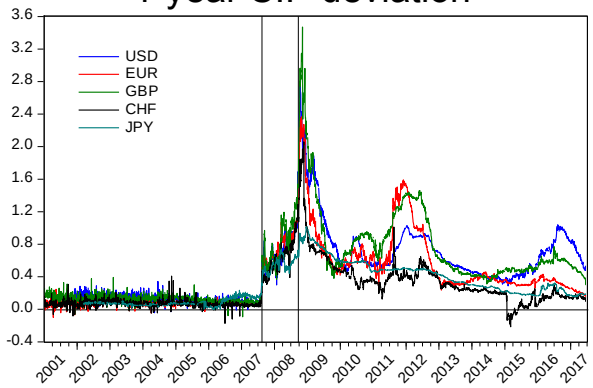
CIP deviation in FX swap and CCBS markets

- Until 2007, CIP was one of the most reliable parity conditions in international finance
- Since GFC, textbook arbitrage has emerged in the cross-currency market

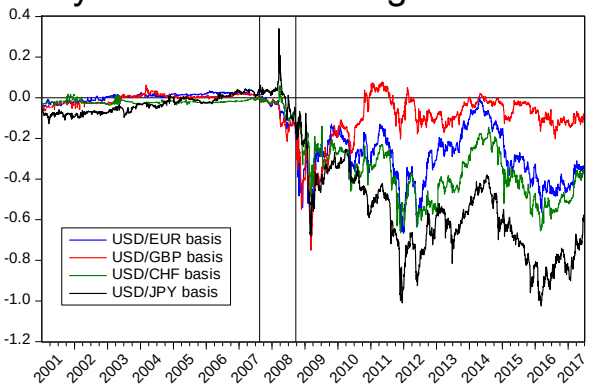
$$\frac{F_t}{S_0} \neq \left(\frac{1 + r_{0,t}}{1 + q_{0,t}}\right)^t$$

- Not a dollar-specific phenomenon

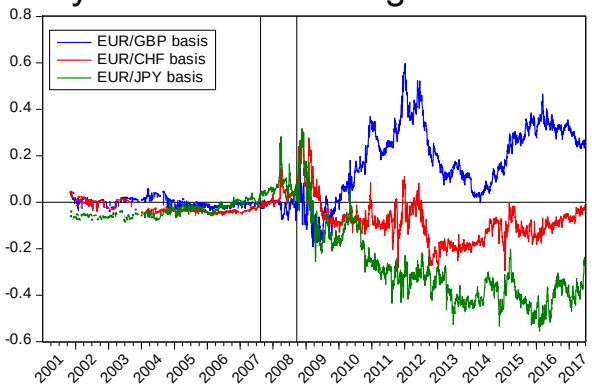
1-year CIP deviation



5-year CCBS basis against USD

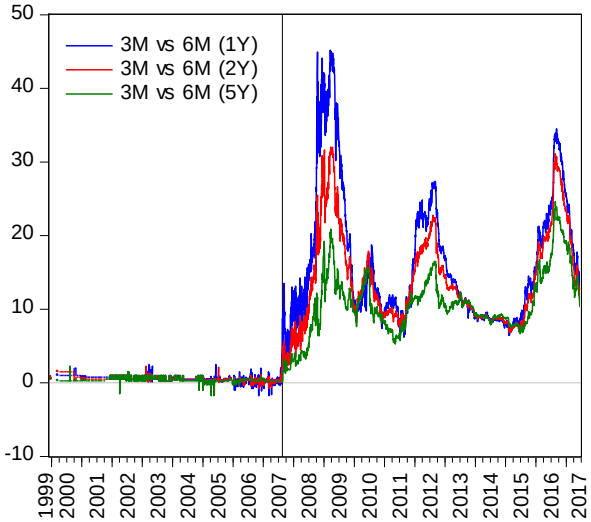


5-year CCBS basis against EUR

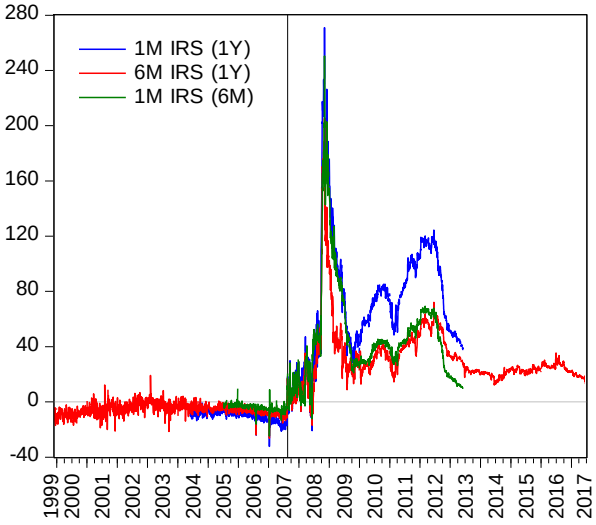


Single-currency basis

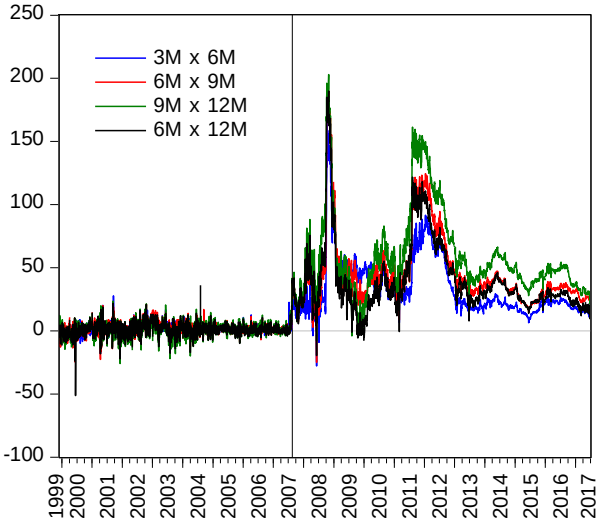
Tenor Basis (USD)



Fix-Float Basis (GBP)



Forward Basis (EUR)

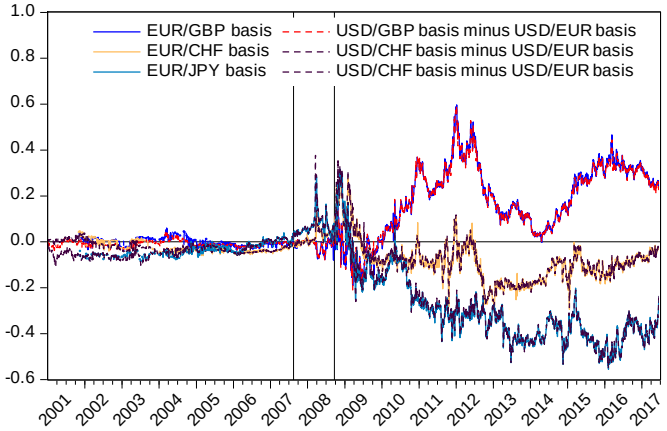


Vertical line represents 9 August 2007 (BNP Paribas suspended redemption for three of its investment funds).
Source: Bloomberg

No arbitrage opportunities

CCBS basis matrix

- CCBS basis matrix $B_n = \left(\alpha_{i,j}\right)_{i,j=1}^{n}$ satisfies: $\boldsymbol{\alpha_{i,j} + \alpha_{j,k} = \alpha_{i,k}}$
  - ❖ *Property 1:* $\alpha_{i,i} = 0$ for $i = 1,2,\dots,n$
  - ❖ *Property 2:* $\alpha_{i,j} + \alpha_{j,i} = 0$ *for* $i, j = 1,2,\dots,n$
  - ❖ *Property 3:* The basis matrix can be entirely determined by its ith row, where $i = 1,2,\dots,n$.



CCBS roundtrip arbitrage

	Currency i	Currency j	Currency k
		Gross cash flows of three contracts	
$t = 0$	1	$-S_j$	
$t = 1$	$-r_i$	$S_j(r_j + \alpha_{i,j})$	
$t = 1$	-1	S_j	
$t = 0$		S_j	$-S_k$
$t = 1$		$-S_j r_j$	$S_k(r_k + \alpha_{j,k})$
$t = 1$		$-S_j$	S_k
$t = 0$	-1		S_k
$t = 1$	$r_i + \alpha_{k,i}$		$-S_k r_k$
$t = 1$	1		$-S_k$
		Net cash flows	
$t = 0$	0	0	0
$t = 1$	$\alpha_{k,i}$	$S_j \alpha_{i,j}$	$S_k \alpha_{j,k}$

	USD	EUR	GBP	CHF	JPY
USD	0	−33.1	−7.4	−35.5	−57.8
EUR	33.1	0	25.8	−1.9	−24.7
GBP	7.4	−25.8	0	−27.6	−50.4
CHF	35.0	1.9	27.6	0	−22.8
JPY	57.8	24.7	50.4	22.8	0

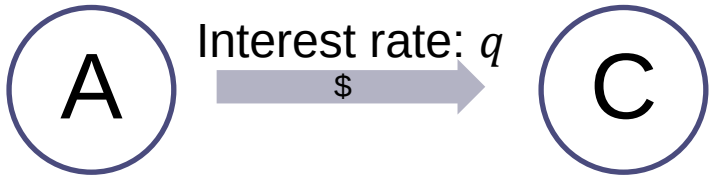
0.7

	USD	EUR	GBP	CHF	JPY
USD	0	−33.1	−6.9	−35.6	−58.5
EUR	33.1	0	26.3	−2.5	−25.4
GBP	6.9	−26.3	0	−28.8	−51.6
CHF	35.6	2.5	28.8	0	−22.9
JPY	58.8	25.4	51.6	22.9	0

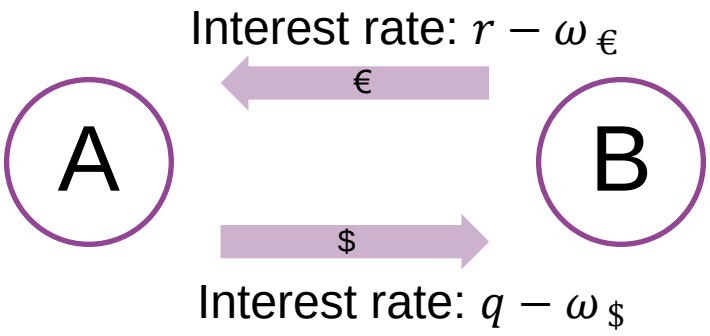
1.2

CIP adjusted by counterparty risks

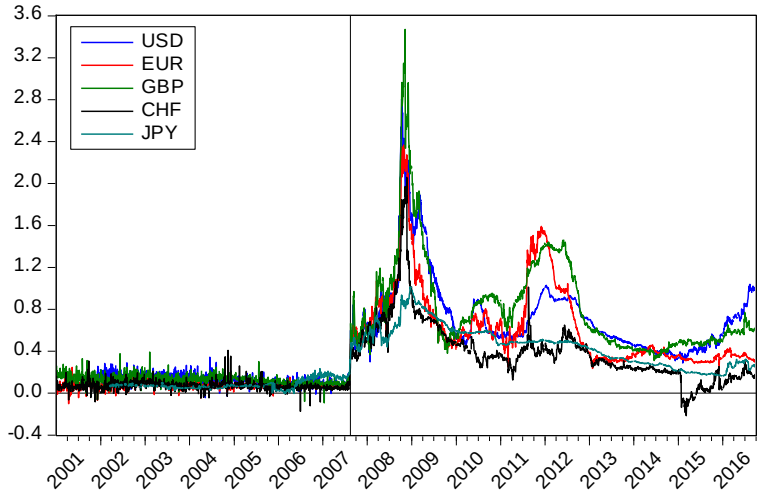
Interbank loan: uncollateralized



FX swap and CCBS: collateralized



Libor-OIS spread increases since 8 Aug 2007



Why no bases before the GFC?

$$\omega_{€} = \omega_{\$} = 0$$

CIP adjusted by counterparty risks

- Aware of the counterparty risks embedded in Libors, it is fair for market participants to adjust for the risks when valuing a product of different risk profile

$$\frac{F}{S} = \frac{1 + r - \omega_r}{1 + q - \omega_q}$$

$$= \frac{1 + r - \beta\,(r - r_f)}{1 + q - \gamma\,(q - q_f)}$$

Exclude counterparty risks from the interbank rate

- However, FX swaps or CCBS are not totally risk-free

$$\frac{F}{S} = \frac{1 + r_f + (1 - \beta)(r - r_f)}{1 + q_f + (1 - \gamma)(q - q_f)}$$

Include funding liquidity risks to the risk-free rate

Estimation

Rearranging the previous equation,

$$\frac{F}{S} = \frac{1 + \beta r_f + (1-\beta)r}{1 + \gamma q_f + (1-\gamma)q}$$

Log transformation

$$lnF - lnS \approx \beta r_f - \gamma q_f + (1-\beta)r - (1-\gamma)q$$

Estimating equation

$$\boldsymbol{\Delta Fp_t = C_0 + C_1 \Delta OIS_t^{FC} + C_2 \Delta OIS_t^{DC} + C_3 \Delta IRS_t^{FC} + C_4 \Delta IRS_t^{DC} + \varepsilon_t}$$

Hypothesis

- Hypothesis 1: $C_0 = 0$
- Hypothesis 2a: $C_1 + C_3 = 1$
- Hypothesis 2b: $C_2 + C_4 = -1$

Data

- 5-year CCBS of 7 currency pairs involving 5 major currencies
  - EUR, GBP, CHF and JPY vis-à-vis USD
  - GBP, CHF, and JPY vis-à-vis EUR
- Sources and availability
  - Sample period defined by data availability covers 22 Sep 2009 to 30 Jun 2017
  - All data collected from Bloomberg
  - Daily frequency and synchronized at London time 6:00 p.m.
- Dealing with outliers
  - Trimming by 5 standard deviations
  - Winsorizing between 0.5%-99.5% percentiles

Metadata

	USD	EUR	GBP	CHF	JPY
			IRS rates		
Reference rate	3M Libor	3M Euribor	3M Libor	3M Libor	6M Libor
Payment frequency	Quarterly	Annually	Quarterly	Annually	Semi-annually
			OIS rates		
Reference rate	Effective Fed funds rate	Euro overnight index average	Sterling overnight index average	Tom/next indexed swap in CHF fixing	Tokyo overnight average rate
Description	A weighted average of rates on trades arranged by major brokers	A weighted average of overnight unsecured lending rates in the interbank market, initiated within the Euro area by contributing banks	A weighted average rate of unsecured sterling overnight cash transactions brokered in London by WMBA member firms	Based on quotations from approximately 30 reference banks for its Tom/next unsecured lending rate to prime banks, supplied to Cosmorex AG	Based on uncollateralized overnight average call rates for lending among financial institutions, published by Bank of Japan
Published by	Federal Reserve Bank New York	European Central Bank	Wholesale Markets Brokers' Association	Cosmorex AG	Bank of Japan

Descriptive statistics

	USD	EUR	GBP	CHF	JPY
5-year forward premium (annualized, %) vis-à-vis USD					
Mean		-0.93	-0.15	-1.77	-2.01
Median		-0.75	-0.04	-1.51	-2.06
Maximum		0.69	0.62	-0.57	-1.10
Minimum		-2.58	-1.59	-3.19	-2.93
Std. Dev.		0.82	0.47	0.66	0.40
Obs.		2,029	2,029	2,029	2,029
5-year forward premium (annualized, %) vis-à-vis EUR					
Mean			0.78	-0.84	-1.08
Median			0.65	-0.80	-0.94
Maximum			2.02	-0.26	0.01
Minimum			-0.36	-1.57	-3.11
Std. Dev.			0.51	0.28	0.69
Obs.			2,029	2,029	2,029
5-year IRS rate (%)					
Mean	1.60	1.01	1.55	0.27	0.26
Median	1.60	0.83	1.45	0.25	0.25
Maximum	2.94	3.10	3.34	1.73	0.78
Minimum	0.72	-0.34	0.30	-1.00	-0.24
Std. Dev.	0.50	0.93	0.69	0.72	0.19
Obs.	2,012	2,029	1,978	2,015	2,029

	USD	EUR	GBP	CHF	JPY
5-year OIS rate (%)					
Mean	1.34	0.78	1.30	0.14	0.14
Median	1.37	0.63	1.18	0.13	0.15
Maximum	2.79	2.82	3.11	1.60	0.57
Minimum	0.47	-0.47	0.13	-0.95	-0.37
Std. Dev.	0.53	0.85	0.68	0.61	0.17
Obs.	2,029	2,029	2,029	1,899	2,029
5-year IRS-OIS spread (bps)					
Mean	26.3	22.7	25.6	5.2	11.2
Median	25.1	19.6	22.7	9.2	10.5
Maximum	55.7	57.6	66.4	32.3	21.6
Minimum	13.0	7.3	12.1	-18.1	2.6
Std. Dev.	7.1	9.6	8.4	9.3	4.0
Obs.	2,012	2,029	1,978	1,887	2,029

Quarter-End Spikes (1W Libor-OIS Spreads)

	USD	EUR	GBP	CHF	JPY	Panel
			Whole period			
Constant	0.1257***	0.0460*	0.0917***	-0.0758***	0.0366***	0.0522***
	(0.0184)	(0.0250)	(0.0146)	(0.0208)	(0.0072)	(0.0017)
Quarter	0.0528***	0.0275**	0.0182**	0.0092	0.0100**	0.0247***
	(0.0085)	(0.0135)	(0.0071)	(0.0167)	(0.0047)	(0.0063)
Obs.	2,501	2,535	2,501	1,815	2,255	11,607
R-squared	0.0023	0.0041	0.0011	0.0002	0.0010	0.1217
			Positive interest rate period			
Constant		0.0735**		0.0250***	0.0417***	
		(0.0291)		(0.0060)	(0.0105)	
Quarter		0.0398**		0.0230***	0.0170***	
		(0.0201)		(0.0065)	(0.0053)	
Obs.		1,751		1,244	1,896	
R-squared		0.0069		0.0023	0.0027	
			Negative interest rate period			
Constant		-0.0156**		-0.2951***	0.0092	
		(0.0070)		(0.0055)	(0.0609)	
Quarter		0.0056**		-0.0242***	-0.0259*	
		(0.0024)		(0.0084)	(0.0141)	
Obs.		784		571	359	
R-squared		0.0047		0.0109	0.0322	

*, **, and *** denote statistical significance at 10%, 5% and 1% levels.

Results

Unrestricted model

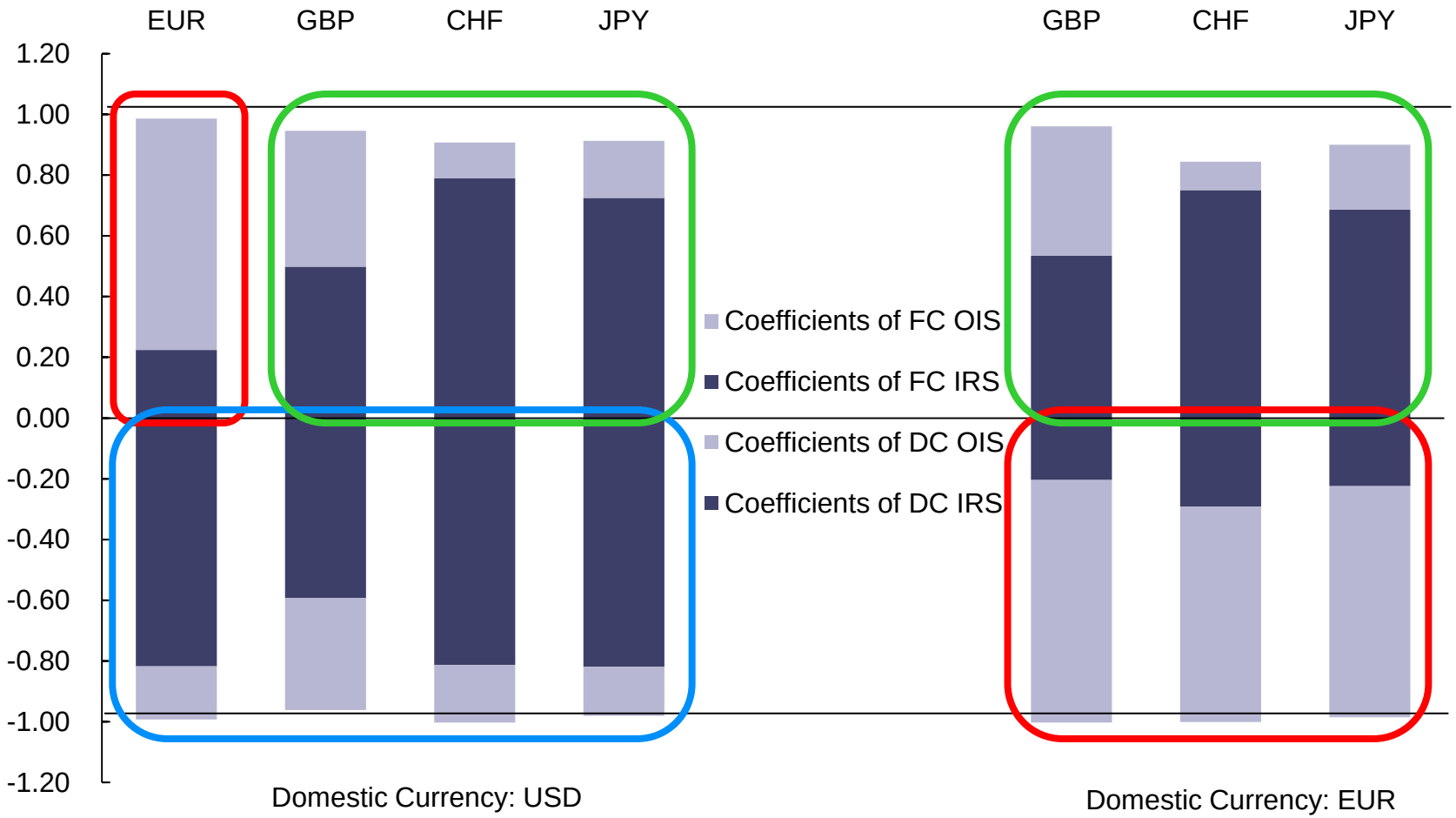
$$\Delta Fp_t = C_0 + C_1 \Delta OIS_t^{FC} + C_2 \Delta OIS_t^{DC} + C_3 \Delta IRS_t^{FC} + C_4 \Delta IRS_t^{DC} + \varepsilon_t$$

Foreign currency	EUR	GBP	CHF	JPY	GBP	CHF	JPY
				Unrestricted model			
		USD as domestic currency			EUR as domestic currency		
Constant	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)
C1 (FC OIS)	0.7616***	0.4480***	0.1175***	0.1882***	0.4262***	0.0936**	0.2143***
	(0.0382)	(0.0446)	(0.0346)	(0.0643)	(0.0505)	(0.0365)	(0.0694)
C2 (DC OIS)	-0.1747***	-0.3682***	-0.1893***	-0.1606***	-0.7986***	-0.7096***	-0.7609***
	(0.0333)	(0.0386)	(0.0556)	(0.0495)	(0.0486)	(0.0723)	(0.0629)
C3 (FC IRS)	0.2246***	0.4979***	0.7899***	0.7243***	0.5343***	0.7506***	0.6860***
	(0.0368)	(0.0445)	(0.0453)	(0.0703)	(0.0514)	(0.0483)	(0.0742)
C4 (DC IRS)	-0.8176***	-0.5927***	-0.8128***	-0.8196***	-0.2042***	-0.2913***	-0.2239***
	(0.0329)	(0.0376)	(0.0548)	(0.0495)	(0.0468)	(0.0699)	(0.0616)
R-squared	0.7986	0.7104	0.6278	0.6873	0.6398	0.3742	0.5183
Adj. R-squared	0.7982	0.7098	0.6270	0.6866	0.6390	0.3729	0.5173
DW Statistics	2.3565	2.7895	2.5773	2.5067	2.5514	2.6928	2.6482

, and * denote statistical significance at 5% and 1% levels.

Results

Sum of shares of counterparty and liquidity risks



Results

Restricted model

$$\Delta Fp_t = C_0 + C_1 \Delta OIS_t^{FC} + C_2 \Delta OIS_t^{DC} + (1 - C_1)\Delta IRS_t^{FC} + (-1 - C_2)\Delta IRS_t^{DC} + \varepsilon_t$$

Foreign currency	EUR	GBP	CHF	JPY	GBP	CHF	JPY
				Restricted model			
		USD as domestic currency			EUR as domestic currency		
Constant	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)
C1	0.7717***	0.4763***	0.1295***	0.2129***	0.4425***	0.1175***	0.2499***
	(0.0365)	(0.0440)	(0.0345)	(0.0607)	(0.0503)	(0.0364)	(0.0655)
C2	-0.1796***	-0.3998***	-0.1997***	-0.1703***	-0.7993***	-0.7238***	-0.7738***
	(0.0326)	(0.0373)	(0.0544)	(0.0490)	(0.0465)	(0.0698)	(0.0612)
R-squared	0.7985	0.7086	0.6254	0.6868	0.6377	0.3643	0.5175
Adj. R-squared	0.7983	0.7083	0.6250	0.6864	0.6374	0.3636	0.5170
DW Statistics	2.3618	2.8025	2.5797	2.5117	2.5587	2.6781	2.6547
Log Likelihood	14317	13581	12269	13398	13471	12313	13458

*** denotes statistical significance at 1% level.

Conclusion

- Breakdown of CIP is no mystery:
  - New trading environment: uncollateralized and collateralized transactions are no longer the same
  - Rational behavior: no more use of “unsecured” interest rates to price “secured” transactions
- It is a myth that breakdown of CIP reflects:
  - Unexploited arbitrage opportunities
  - Market failure
- The basis matrix challenges:
  - Quantity constraints cause limits to arbitrage
  - CIP deviation is a dollar phenomenon