Lesson 07　Interbank market

The “interbank market” is a market where banks and other financial institutions conduct money lending and borrowing transactions (non-financial institutions cannot participate※9). The “interbank market” is a market in which “Bank of Japan current accounts” where financial institutions lend and borrow funds to invest surplus funds or procure insufficient funds.

Two typical transactions in the interbank market are as follows

- ☑ Call Transactions (Significant Markets)
- ☑ Bill transaction

(1) Call transaction

It is a short-term fund lending transaction between financial institutions, and is most commonly used by banks and other financial institutions with insufficient current account balances at the Bank of Japan to raise funds for the time being. The word “call” means “to call and have it returned immediately.”

The transaction type is either a “secured call” in which the borrower pledges collateral to the lender, or an “unsecured call” in which no collateral is pledged. Both secured and unsecured calls can be made for various lengths of time, up to one year. The types can be divided into three categories.

- ☑ Overnight
- ☑ Open-end item
- ☑ Fixed term item

An open-end item starts out as a one-day loan, but if the loan is not repaid, it automatically rolls over (continues). Fixed term item is loans other than overnight loans that have a clearly defined repayment date.

Particularly large numbers of transactions are in overnight contracts that start on the same day. The majority of these transactions are for the purpose of "adding cash flow to financial institutions". Financial institutions can have surpluses or shortfalls in their cash holdings due to a variety of factors, the main ones being.

※9 The Bank of Japan, brokers for short-term money transactions, etc. can participate.

☑ Funds Settlement

Receipt and disbursement of deposits, lending, bill clearing, domestic and foreign exchange, etc.

☑ Investment and financing in financial instruments

Buying and selling stocks and bonds, buying and selling foreign exchange, etc.

Funds supplied to the call market from the perspective of the originator (trust banks, regional banks, insurance companies, etc.) are call loans, and funds raised in the call market from the perspective of the receiver (city banks, etc.) are call money.

The call market also functions largely as a place to coordinate the uneven distribution of funds[※10] in the market among financial institutions.

（2） Bill transaction

There is a financing method called "bill discounting" in which a company passes a bill it holds to a bank and receives a loan at a discount of the face value of the bill. The bill transactions referred to here are also transactions in which a financial institution raises funds by passing a bill it holds to another financial institution.

Currently, however, bill transactions are rarely used as a means of lending and borrowing funds between private financial institutions. They are only used as a means of open market operations conducted by the Bank of Japan.

※10 A surplus of funds where the amount received (borrowed from financial institutions, deposits, etc.) exceeds the amount of credit (invested, i.e., loans and investments in securities) is called a loan position, and the opposite is called a money position.

Lesson 08　Open market

A short-term financial market in which participants are open to a wide range of people other than financial institutions is an open market. Typical examples are as follows

① T-Bill market
② CD market
③ CP market
④ Bond Repo market
⑤ Offshore market

（1） T-Bill market

Until January 2009, TBs and FBs were classified as short-term government bonds as follows, but they were integrated into the T-bill (Treasury Discount Bill) market in February 2009.

☑ TB (Treasury Bills)

Discounted Treasury Bills. There are two types of TBs with redemption (maturity) periods of 6 months and 1 year. TBs are issued to refinance long-term JGBs and other government bonds.

☑ FB (Financing Bills)

Financing Bills. In principle, the term is 13 weeks.

FBs are issued to meet a temporary shortage of funds of the government.

The T-bills are issued for short-term cash management and have maturities of 2 months, 3 months, 6 months, and 1 year.

Since they are government debt certificates, they are naturally highly creditworthy and the size of the issue is large, so they have a high share in the short-term money market as bonds with sufficient liquidity. Until around June 2013, the 3-month yield was around 0.1%, but the yield has been “negative” since 2015 due to the monetary easing policy.

（2） CD market

A CD (Negotiable Certificate of Deposit) is a transferable deposit. In principle, a depositor cannot transfer the right to receive reimbursement to a third party in a general deposit, but in a CD, the right can be transferred to a third party, i.e., the deposit can be sold, if certain procedures are followed.

In addition, CDs are not simply applied for over the counter like ordinary deposits, but are issued on their own terms and conditions through individual negotiations between banks and investors who manage large funds. Transactions using the "repurchase agreement" method, which will be discussed later, are also actively conducted.

Note that CDs are often classified as short-term financial transactions because they are generally issued for a period of one year or less, but there are also instruments with a term longer than one year.

The market size is around 36 trillion yen (at the end of December 2021) according to BOJ statistics (domestic banks).

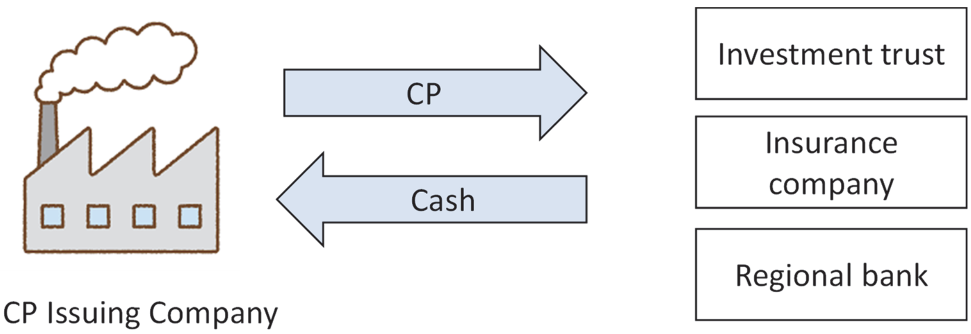
（3） CP market

CP (Commercial Paper) is a promissory note issued by general companies to borrow unsecured funds, and its issuance began in 1987.

There are other means for companies to raise funds other than bank loans, such as "bond issuance" and "new stock issuance (equity finance)," but these are long-term fundraising methods and incur large administrative costs. On the other hand, CP is a relatively simple form of short-term financing. In the past, there were various restrictions on issuance periods, amounts, and companies that could issue CP, but these have all been eliminated. However, CP is usually issued after obtaining a rating from a rating agency.

Most CP issues are underwritten by banks and securities firms, and the amount of CP issued has decreased from over 20 trillion yen to less than 20 trillion yen since the 2008 Global Financial Crisis. However, the environment has improved and CP issuance has recovered to the 20 trillion level by 2021.

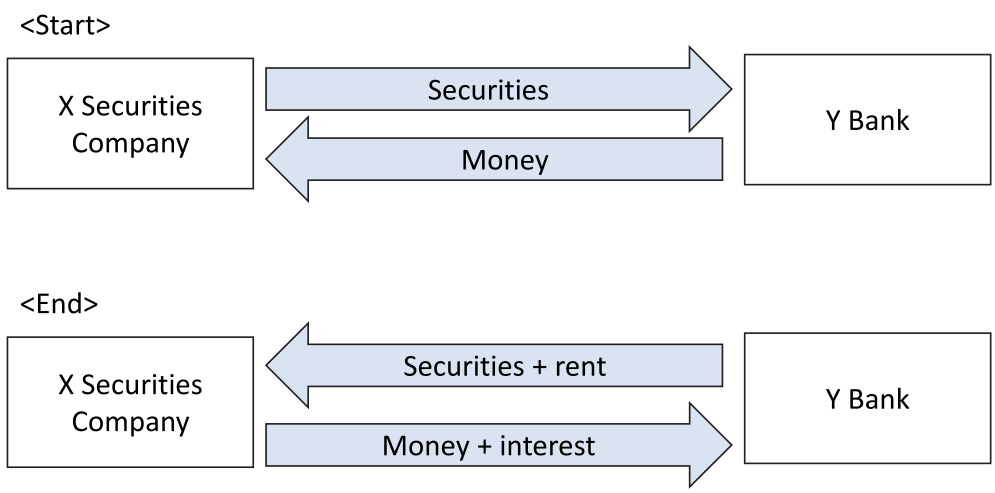
Figure 9 Issuance of CP



（4） Bond repo market

A bond repo transaction is a form of funds lending transaction in which a bond is pledged as collateral to a money lender, and is Securities firms often use this transaction to raise funds.

Figure 10 Bond repo market



Exchange of lent charge and interest rates at the end of the transaction

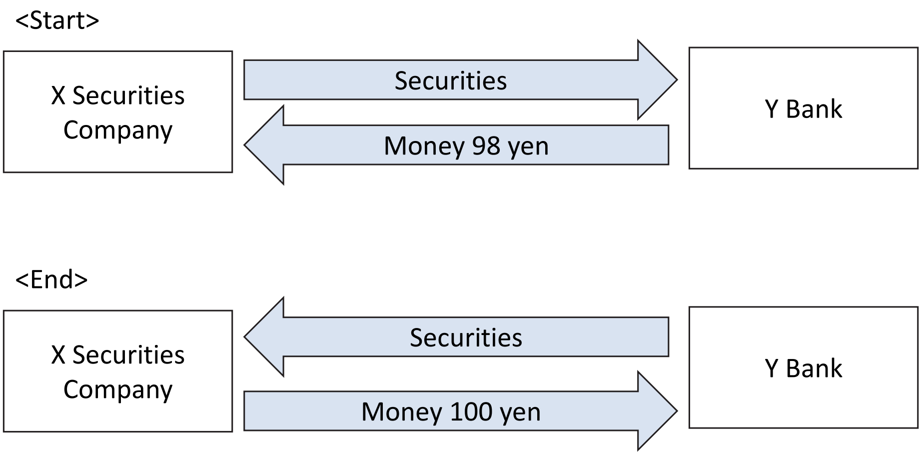
- ☑ The borrower of the funds pays interest on the borrowed money to the originator of the funds.
- ☑ The borrower of the bond pays the lender of the bond a lent charger for the bond.

Bond repo transactions are not always done to borrow money, but may be done to borrow certain bonds or other securities. In this case, if the bond is rare, the real interest rate paid by the borrower of the funds may be negative. The transaction on the borrower side of the funds is called a "repo." The transaction on the borrower side of the bond is called a "reverse repo." In the above, the "interest rate – rent charge" is called the "repo rate."

The word "repo" is said to come from "repurchase agreement." The repo market has a strong presence in the short-term money market and is subject to the Bank of Japan's operations because of its particularly large impact on bonds, and rates are published daily as the Tokyo Repo Rate by the Japan Securities Dealers Association. [※11]

A very similar form of transaction to a bond repo is a "repurchase/resale agreements." These days, repurchase /resale agreements are generally referred to as bond repo transaction. A repurchase/resale transaction is a transaction in which a financial institution that wishes to raise funds sells a bond or other instrument on a "repurchase" condition, or a financial institution that wishes to invest funds buys a bond or other instrument on a "sell-back" condition. While repo transactions are bond lending transactions ("loan for consumption" under the Civil Code), repurchase/resale transactions are conditional sales transactions ("sales contracts" under the Civil Code).

Figure 11 Examples of repurchase agreements



If we only look at the flow of money, X Securities is raising funds and Y Bank is investing funds. Comparing the flow of bonds and money with repo transactions shows that economically they are the same transactions. Note that repurchase/resale agreements are also made on CDs, CPs, etc.

※11 Tokyo Repo Rate (Japan Securities Dealers Association Website)
https://www.jsda.or.jp/shiryoshitsu/toukei/trr/index.html (last retrieved on January 17, 2021)

（5） Offshore market

The offshore market was established in 1986 as a place for non-residents of foreign governments and international organizations to raise and invest funds.

At the time, Japan's financial sector still had many regulations that were unique to the country, and there was pressure from other countries to abolish these regulations. Against this backdrop, the Offshore Market was established to provide non-residents with a place where they can trade freely without being subject to domestic regulations. However, this does not mean that there is an exchange as "offshore market," but rather that rules have been established to allow non-residents to trade without having to comply with domestic regulations.

Domestic financial institutions can also set up special "offshore accounts" (managed separately from general domestic accounts) and participate in such accounts. However, with the current deregulation of the market, trading conditions no longer differ significantly from those of domestic transactions.

1． What is Euro yen?

Loan transactions of yen funds traded in the offshore market are called "Euro yen" transactions.

Usually, the term Euro XX, such as Euro yen, Euro dollar, etc., refers to money traded outside the country where the currency is originally created (i.e., Euro euro is the Euro that exists outside the Euro zone). Since offshore markets are not subject to domestic regulations, they can be viewed as "foreign markets" within Japan. Therefore, the yen traded in the offshore market is also called "Euro yen."

2． LIBOR and TIBOR

LIBOR (London Interbank Offered Rate) is the level of short-term interest rates used for money lending and borrowing transactions such as "Euro yen" and "Eurodollar." LIBOR is the average interest rate on the London interbank market. In the past, the British Bankers Association (BBA) interviewed a predetermined number of financial institutions and averaged the results for publication. However, due to the discovery of fraud[※12] in the process of determining the rate, the Intercontinental Exchange (ICE), a major US exchange, began calculating and publishing the rate on February, 2014.

TIBOR is Tokyo's version of LIBOR, and there are two types of TIBOR: Euro yen TIBOR, which reflects short term interest rates in the offshore market in Tokyo, and Japanese Yen TIBOR, which reflects rates in the unsecured call market. However, there is a study underway to unify these two types of TIBOR into the "Japanese Yen TIBOR."

※12 LIBOR rigging case in 2012

3． Suspension of LIBOR

London has long been known as a less regulated international market, and LIBOR was customarily used for short-term interest rates in international transactions and derivatives trading. However, LIBOR, the interbank lending rate, was suspended at the end of 2021 (the suspension was extended to the end of June 2023 for the U.S. dollar) because it was generally recognized that it was not a "risk-free rate (RFR)." The successor index to LIBOR will be the overnight interest rate of each currency, which is considered to be the RFR.

Figure 12 LIBOR successor indicator for each currency

Currency	LIBOR Successor Indicators
US dollar	SOFR (Secured Overnight Financing Rate)
Japanese Yen	TONA (Tokyo Overnight Average rate)
British pound	SONIA (Reformed Sterling Overnight Index Average)
Euro	€STR (Euro Short-Term Rate)
Swiss franc	SARON (Swiss Average Rate Overnight)