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LIBOR vs. OIS: The Derivatives Discounting Dilemma

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John C. Hull (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=224834)
University of Toronto - Rotman School of Management

Alan White (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=296747)
University of Toronto - Rotman School of Management

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Abstract

Traditionally practitioners have used LIBOR and LIBOR-swap rates as proxies for risk-free rates when valuing derivatives. This practice has been called into question by the credit crisis that started in 2007. Many banks now consider that overnight indexed swap (OIS) rates should be used as the risk-free rate when collateralized portfolios are valued and that LIBOR should be used for this purpose when portfolios are not collateralized. This paper examines this practice and concludes that OIS rates should be used in all situations.

Keywords: LIBOR, OIS, Derivatives, Discounting

JEL Classification: G21, G33

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