THE RISE IN LIBOR

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Executive Summary

• The rise in LIBOR in early 2018 is a function of technical external factors and not a sign of stress in the financial markets.

• No immediate impact on the credit quality of insurer investment portfolios, but high yield issuers and others that rely heavily on the short-term and variable rate markets for funding should be monitored closely.

• LIBOR to be phased out over the next several years, with alternatives currently being tested.

• The transition away from LIBOR will require market participants, including insurance companies, to review all financial contracts that reference the short-term rate.
What is LIBOR?

The interest rate which banks offer to lend money to one another on a short-term basis in the Eurodollar market.
Applications of LIBOR

- Primary benchmark for short-term and variable interest rates
- Used to set interest rates on about $350 trillion of assets

Corporate Bonds  Home Mortgages  Business Loans  Derivatives Contracts
LIBOR Reform

Markets expected to transition away from LIBOR due to price manipulation concerns that came to light in 2012

- U.K. – Financial Conduct Authority (Britain’s primary financial regulator) will stop requiring banks to provide quotes used to calculate LIBOR by the end of 2021

- U.S. – Testing alternative rate based on the cost of overnight loans, or repurchase agreements
  - Secured Overnight Financing Rate (SOFR) launched in April 2018
  - Transition will be gradual and complicated
    - SOFR term structure will need to be built out
    - Agreements referencing LIBOR will need to be revised if they do not have replacement language
LIBOR Spikes in 2018

- Steady and gradual increase in 2016 and 2017
- Rise accelerated in 2018, climbing to 2.37% in early May
- Highest level since October 2008 but still over 200 bps lower than the last peak
Why Did LIBOR Spike?

During Financial Crisis...
- Lack of trust between banks leads to reluctance to lend to one another
- Stress in banking sector
- Capital markets (money markets in particular) froze
- No market liquidity

Today...
- Corporate tax reform
- Increase in short-term U.S. Government debt issuance
- Unwinding of the Fed’s balance sheet
- Market liquidity unaffected by these technical factors
Technical Factors Lead to Rise in LIBOR

- **Tax Reform**
  - Eliminates incentive to keep dollars offshore
  - Decreases the supply of dollars for short-term lending in the Eurodollar market, driving LIBOR higher

- **U.S. Treasury Issuance**
  - Commercial paper (CP) has had to offer higher rates to compete with Treasuries for investors
  - Higher CP rates feed into LIBOR (because of the lack of interbank transactions)

- **Unwinding Fed Balance Sheet**
  - Drains excess reserves in the market
  - Tightens funding, leading to higher rates overall
Implications of LIBOR Increase to Insurer Investment Portfolios

• No imminent threat to the health of most borrowers despite increase in borrowing costs

• However, together with rising interest rates, higher borrowing costs will lead to tighter financing conditions and less funding liquidity
  – Highly leveraged borrowers in particular may face financing challenges

• European and Japanese banks rely heavily on Eurodollar markets, so borrowing costs will rise
Useful Links

• **ICE LIBOR**
• **LIBOR FAQs**
• **Oliver Wyman Report on LIBOR Transition**