Capital Markets Bureau Market Buzz

THE RISE IN LIBOR

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National Association of Insurance Commissioners

Analyst: Michele Wong

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

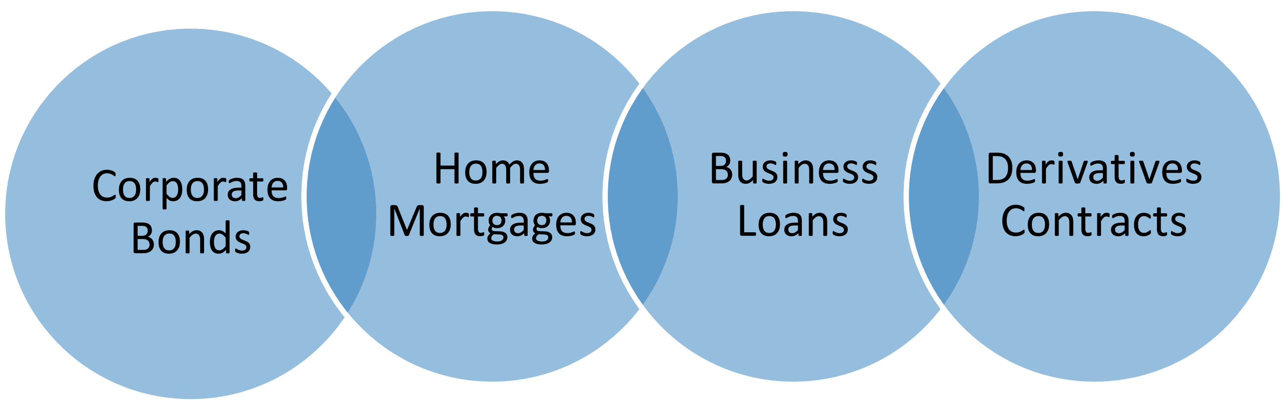
What is LIBOR?

- **L**ondon
- **I**nter
- **B**ank
- **O**ffered
- **R**ate

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



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