

LIBOR'S FATE: COULD IT BE FOR REAL THIS TIME?

By **Kevin Flanagan**, Senior Fixed Income Strategist

Over the last few years or so, a number of stories have suggested the demise of the London Interbank Offered Rate (LIBOR), but until recently, they were just that—stories. But this summer, Andrew Bailey, CEO of the U.K.'s Financial Conduct Authority (FCA), announced that LIBOR would be discontinued at the end of 2021. Because the FCA is the regulatory body for LIBOR, the financial markets took particular notice this time around, and they seem to acknowledge that LIBOR'S rumored fate could be for real this time.

WHAT IS IT?

LIBOR is the average rate at which major banks offer to lend to each other for short-term unsecured funds in a particular currency for a particular maturity in the wholesale money market in London. It is produced for five different currencies: the U.S. dollar, Japanese yen, British pound sterling, euro and Swiss franc. It can range from overnight to one year, and it's utilized as a benchmark for various loans and in the capital markets. Some examples include mortgages and floating rate vehicles in the fixed income universe.

WHY DOES IT MATTER?

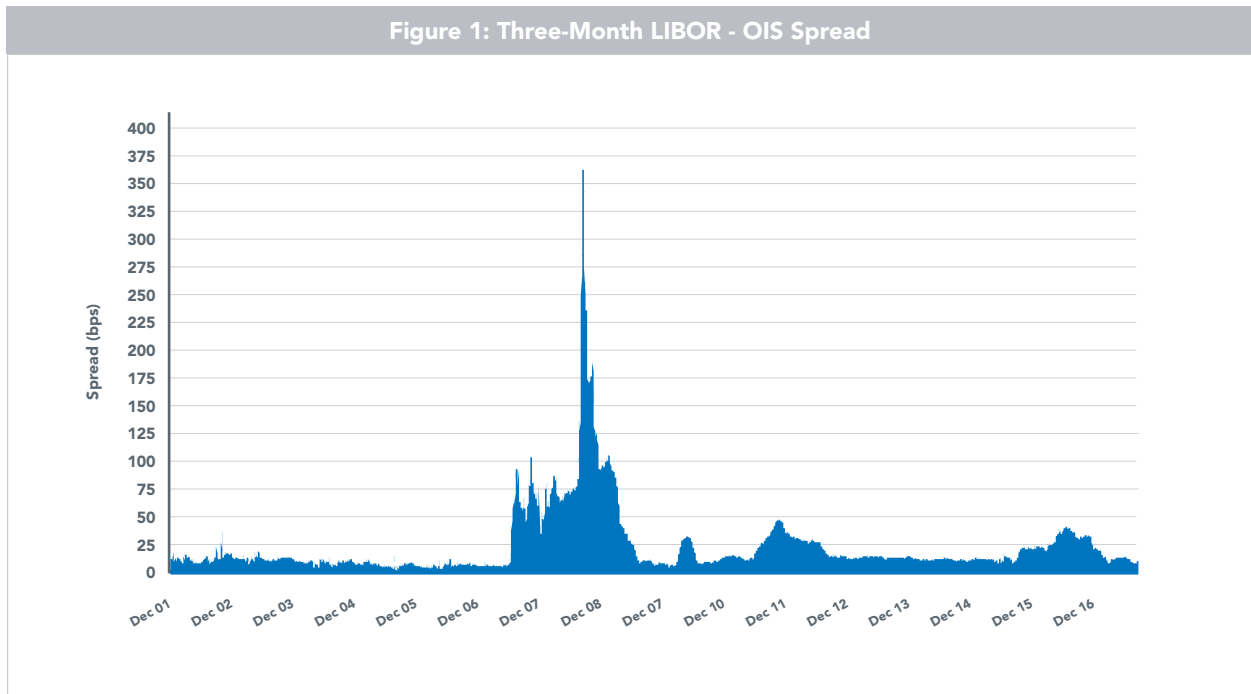
This is the point that goes to the heart of the matter. LIBOR's status as a key benchmark rate means its overall impact is meaningful and affects the economy, financial markets and, potentially, investor behavior. LIBOR is the global borrowing benchmark for more than \$350 trillion of financial products.¹ Thus, homeowners with floating rate mortgages tied to LIBOR and investors who have acquired fixed income products, such as fixed-to-floating rate structures also tied to LIBOR, could all be affected if, in fact, this benchmark is discontinued in four years.

In addition, I have written prior blog posts and mentioned the importance of LIBOR as a gauge to help investors see what is going on in the arena where banks fund themselves on a more short-term basis. The preferred gauge to measure potential credit risk on this front is the LIBOR–OIS spread. The OIS—overnight indexed swap—is an interest rate swap that consists of both a fixed and floating rate component. The floating rate part uses an overnight rate index—in the case of the U.S. dollar, the Federal Funds Rate—while the fixed portion is set at a rate that's agreed upon by the two parties. Thus, the OIS is considered a proxy for the Federal Funds Rate (Fed Funds).² The LIBOR–OIS spread represents the difference between these two instruments and measures one that could contain potential credit risk (LIBOR) versus one that essentially does not (Fed Funds). When this spread widens, it is considered to be a sign that there are stresses in the short-term bank funding markets.

¹ Bloomberg: Libor's Demise by 2021 Hastens Quest for Benchmark Replacements, 7/28/2017

² Federal Funds Rate: The rate that banks that are members of the Federal Reserve System charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

This gauge proved to be very useful during the financial crisis and was also utilized to see what funding stresses, if any, were evident during the 2012 eurozone crisis and last year’s potential fallout from the Brexit vote. The more closely watched gauge is the three-month LIBOR–OIS spread. This graph clearly reveals that, prior to the financial crisis and subsequent Great Recession, this spread was a narrow one. Between December 2001 and July 2007, the mean (or average) differential was a modest 11 basis points (bps)³, and at one point in 2006, it reached a low point of only about 2 bps. Meanwhile, underscoring the fears brought on by the financial crisis, the spread built up to a crescendo in the fall of 2008, reaching an unbelievable peak of 364 bps that October. During the eurozone’s woes, the differential reached a high point of 50 bps in January 2012, and post-Brexit, the spread widened to 44 bps before moving back down to where it resided as of this writing, or 13 bps.



Source: Bloomberg, as of 12/5/17

³ Basis point: 1/100th of 1%.

HOW DID WE GET HERE?

As mentioned in the opening paragraph, on July 27 the FCA revealed its intention to discontinue LIBOR by the end of 2021. In his speech, CEO Bailey acknowledged that there had been significant improvements made to LIBOR to help address prior shortcomings, but “the absence of active underlying markets raises a serious question about the sustainability of the LIBOR benchmarks that are based upon these markets.” Remember, LIBOR is not based on an actual funding rate that is secured; rather, it’s based on a panel of contributor banks that submit rates that are anchored “to the greatest extent possible to actual transactions,” and they are unsecured. With quantitative easing⁴ by major central banks exploding their respective balance sheets, banks have been flooded with excess liquidity,⁵ essentially removing the relatively few eligible term borrowing transactions to which banks’ LIBOR submissions could be directly tied. With this activity expected to remain limited and an active market ceasing to exist, the question became, “How can even the best-run benchmark measure it?”⁶

WHAT ARE THE NEXT STEPS?

With such a sweeping change potentially on the not too distant horizon, the transition process needs to be as seamless as possible—no easy task considering the multitrillion dollars’ worth of instruments that can be affected. First on the to-do list will be to maintain the integrity of LIBOR as the benchmark through the end of 2021. In late November, there was good news on this front, as the FCA confirmed that all 20 banks on the panel agreed to support LIBOR as a benchmark during this period, hopefully ensuring its sustainability until an alternative is found.

Given LIBOR’s somewhat rocky history, the U.S., U.K., Japan, Switzerland and eurozone all had formed groups to study and plan for the day that LIBOR could go away, so that they wouldn’t be unprepared for such a development. Obviously, a key part of their task was to identify a viable replacement, and the results thus far have varied, with some instruments tied to both secured and unsecured markets.

For this post, I will keep the topic U.S.-centric. In 2014, the Fed, under the direction of the Treasury’s Financial Stability Oversight Council, created the Alternative Reference Rates Committee (ARRC). The ARRC is a group of major primary dealers in the U.S. that was tasked to identify an alternative benchmark rate that would be “more firmly based on transactions from a robust underlying market,” as per the N.Y. Fed’s website. The committee decided to utilize a broad Treasury repurchase agreement, a repo rate that is secured or collateralized by Treasuries and is based on \$660 billion in daily transactions. The N.Y. Fed issued a request for public comments on a proposal for three new reference rates based on overnight repos, with the first one, the Secured Overnight Financing Rate (SOFR), chosen as LIBOR’s replacement. The plan is to begin publishing this rate some time in 2018. Since current LIBOR also has term structures (one, three, six, and twelve months), it will be interesting to see if the N.Y. Fed will be publishing rates for these maturities as well.

⁴ Quantitative Easing (QE): A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

⁵ Liquidity: The degree to which an asset or security can be bought or sold in the market without affecting the asset’s price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

⁶ The Future of Libor, speech by Andrew Bailey, Chief Executive of the FCA, at Bloomberg London, 7/27/2017

CONCLUSION

Obviously, the scope of this transition cannot be minimized, and when undertaking such a task, skeptics will no doubt materialize. Fed Chair-in-waiting Jay Powell has been part of the process to find a LIBOR alternative prior to being nominated for the top central bank post. In remarks to a roundtable of the ARRC in November, he stated, "Of course, LIBOR may remain viable well past 2021, but we do not think that market participants can safely assume that it will."

To be sure, a key question to be resolved will be: What happens to my LIBOR-based obligation, and what fallback rates/provisions potentially are in place? Certainly, the time between now and 2021 will be chock-full with headlines, and, more than likely, not all of the questions will be answered. In fact, perhaps some of the answers may just elicit more questions. As a result, our plan is to make this post the first in a series that we hope will serve as a guide for investors as we all go through this rather uncertain time together.⁷

⁷ Remarks by Fed Governor Jerome Powell at the Roundtable of the Alternative Reference Rates Committee, 11/2/2017

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WTGM-0273