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The Transition Away from Libor

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FCA Announces a Libor "End Date"

On July 27 Andrew Bailey of the U.K. Financial Conduct Authority (FCA) delivered a key speech on the future of the London Interbank Offered Rate (Libor), which the FCA regulates. In it, he noted that there are not sufficient underlying interbank transactions to continue relying on Libor as a benchmark rate. He also warned that the FCA has spent a lot of time persuading panel banks to continue submitting Libor rates, and while the FCA has authority to compel banks to participate, that authority runs out before long. If banks eventually leave the panel, Libor's credibility would be further undermined and continued publication of Libor could be jeopardized.

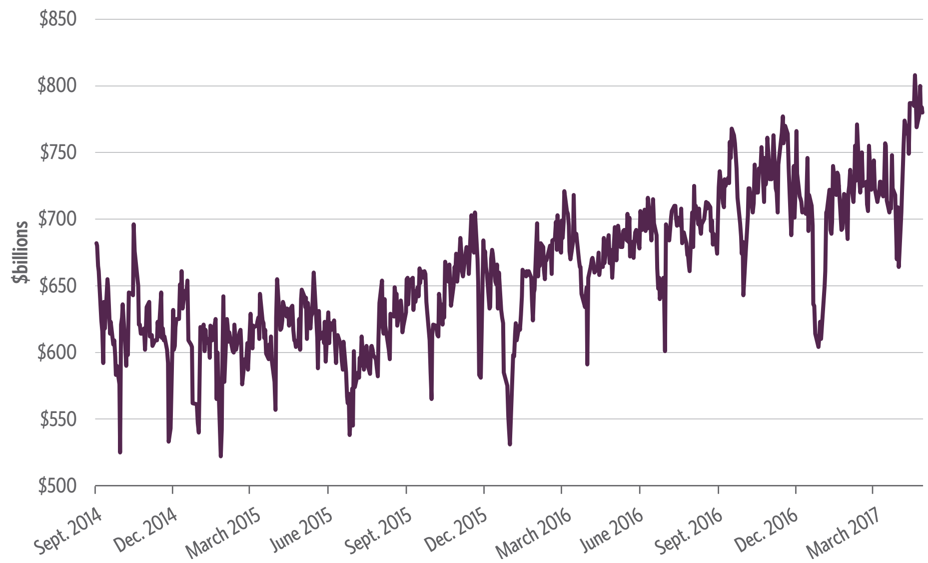
As such, the FCA has worked with panel banks and other regulators to identify the end of 2021 as the period through which Libor will be sustained. This will give relevant stakeholders time to identify alternative benchmarks and to implement transition plans. Libor's future beyond 2021 will be determined by ICE Benchmark Administration (the Libor administrator) and panel member banks, some of which have raised concerns about potential legal liabilities associated with submitting rates that are not based on underlying transactions. Thus it is likely that some banks will choose to leave the Libor panel once they are able to, making Libor's continuation beyond 2021 far from certain.

Libor Alternatives

Libor fixings are currently published in five currencies (USD, EUR, JPY, GBP, CHF). Regulators and market participants in each jurisdiction are working to identify transaction-based alternative rates and to spell out transition plans. This process has been ongoing in the U.S. for a number of years, spurred by the assessment by the Financial Stability Oversight Council (FSOC) in 2013 that the financial system's reliance on Libor posed a significant threat to U.S. financial stability.

In June the Alternative Reference Rates Committee (ARRC), a group of market participants convened by the Federal Reserve (Fed), selected the Broad Treasuries Financing Rate (BTFR) as its preferred USD Libor alternative. This new overnight general collateral (GC) Treasury repo rate, explained in more detail here, will aggregate nearly $800 billion in daily transaction volumes across the tri-party repo market, the inter-dealer GCF repo market and certain bi-lateral repo trades cleared by the FICC (see chart below). Transactions involving the Fed will be excluded.

Transaction Volumes Underlying BTFR Are Significant



Source: Guggenheim Investments, Federal Reserve Bank of New York. Data through 4.28.17.

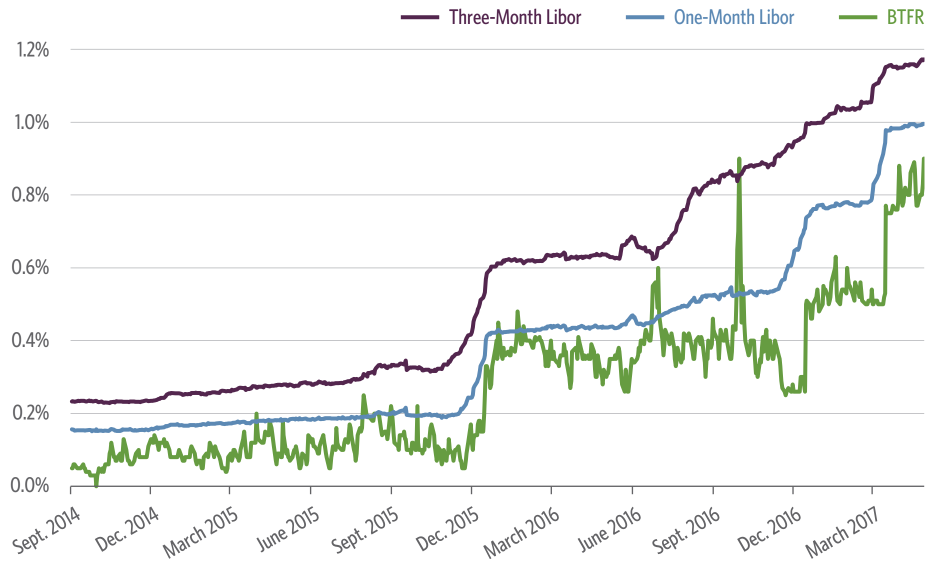
Transition Plan

The transition process for moving away from Libor remains highly uncertain, and a considerable amount of work is yet to come. The ARRC has stated that it intends to publish a transition plan before the end of 2017. The next step in the process would be the start of publication of BTFR by the New York Fed, which is slated for sometime in the first half of 2018. Around the same time we would expect the development of exchange-traded and OTC derivatives contracts referencing BTFR.

We anticipate that BTFR will also likely be incorporated into floating-rate securities as well as consumer and business loans at some point. A critical question for the ARRC to address is what will happen to legacy contracts, loans and securities referencing Libor. We expect that the ARRC transition report will specify how the transition to the new repo rate will occur, both for instruments with existing documentation that contains a provision for a Libor alternative as well as for those without such provisions.

It also remains unclear how parties will agree to bridge the gap between Libor and BTFR for existing instruments. For example, in 2016 BTFR averaged 35 basis points while one-month Libor averaged 50 basis points and three-month Libor averaged 75 basis points (see chart below).

The BTFR Is Lower and More Volatile than Libor



Source: Guggenheim Investments, Federal Reserve Bank of New York. Data through 4.28.17.

Market Implications

We see the potential for market dislocations as cash and derivatives positions are adjusted during the transition period. Liquidity could also deteriorate. For example, once derivatives contracts referencing BTFR are introduced, liquidity could become more fragmented across swaps and futures contracts referencing Libor, the effective fed funds rate, and BTFR.

We also envision new basis risks, as the new Treasury repo rate will behave differently than Libor, particularly during periods of market stress. For example, in 2008, 2011 and 2016 USD Libor rates increased relative to Treasury repo rates amid funding market stresses, benefiting investors in floating-rate loans/securities and those who had short positions in Eurodollar contracts or pay-fixed positions in swaps. In contrast, Treasury repo rates rose relative to Libor during the Fed's Operation Twist program in 2012, during the debt ceiling episode in 2013 and in early 2017 as the stabilization of prime money fund balances curtailed increases in Libor even as the fed funds target increased.

We will continue to monitor developments surrounding the transition away from Libor and assess potential market implications as more details become available.

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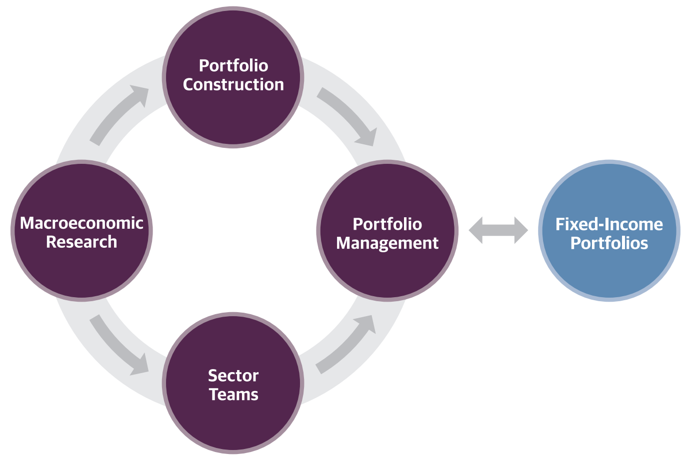

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