Tortoise QuickTake Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provides a timely update on trending topics in the market.

Hello and welcome to the Tortoise Credit Strategies weekly podcast. I'm Greg Haendel, one of the senior portfolio managers on the investment team at Tortoise Credit Strategies.

There are only a few certainties in life: death, taxes and change. When questioned about what's going to change in the next 10 years, Jeff Bezos rhetorically answers what's *not* going to change in the next 10 years. The financial markets are currently grappling with some large changes in the future, notably the potential for near-term tapering of quantitative easing (QE) out of multiple global central banks and the end of LIBOR, also known as the London Interbank Offered Rate. In today's podcast, we will address LIBOR, specifically what it is, why it must change, what are the replacements and what are the potential implications. To hear more about the tapering of QE, please listen to or read our podcast from June 20th, where we discuss the QE change in detail.

LIBOR is an average of the estimated interest rate that a high quality bank in London would be charged to borrow from other leading banks. In essence, it is a short-term, unsecured interest rate charged between banks for wholesale funding. However, LIBOR is also the primary benchmark for short-term interest rates around the world. LIBOR rates are calculated for five currencies and seven borrowing periods, ranging from overnight to one year and are published each business day. Daily LIBOR interest rate fixings have been published since January 1st, 1986, and have since become deeply entrenched into the global financial markets. Many financial institutions, mortgage lenders and credit card agencies set their own interest rates relative to LIBOR. In fact, over $350 trillion dollars worth of financial derivative contracts, mortgages, bonds, and retail and commercial loans have their interest rates tied to LIBOR. You, the listener or reader of this podcast, probably have at least one financial instrument, such as a mortgage, home equity line of credit or business loan that has an interest rate tied to LIBOR.

You may be asking yourself why we would want to change a financial interest rate benchmark that has become so entrenched within our financial system. The answer has to do with the relevance of LIBOR and the liability associated with submitting estimated LIBOR rates. Post financial crisis regulation has significantly reduced bank appetite to issue commercial paper and wholesale deposits. As such, there is now a very low volume of transactions for banks to base their LIBOR submissions, and as a result, banks must rely upon their "expert judgement," translating other interest rates into a LIBOR rate. In fact, submissions based upon "expert judgement" as opposed to real transactions now make up 70% of the daily three-month LIBOR submissions, according to Barclay's Bank. The liability associated with generating such an important and highly-utilized interest rate based upon expert judgement is enormous, especially in the wake of the LIBOR fixing scandals. During this scandal, it was discovered that some banks were falsely inflating or deflating their rates in order to profit from trades or to give the impression that they were more creditworthy than they actually were.

The Financial Conduct Authority (FCA) is the regulatory agency currently responsible for overseeing LIBOR, while ICE Benchmark Administration (IBA) is currently responsible for administering and publishing LIBOR. The FCA and IBA are aware of the concerns with LIBOR, and a global effort has been underway to find new benchmark rates to replace LIBOR. On July 27th, the CEO of the FCA created a stir in the market when he recommended an expiration date for LIBOR, or more specifically recusal of their regulation over LIBOR at the end of 2021. By using a set date, the FCA is hoping to get all market participants involved in finding alternatives, rather than simply ignoring this herculean task. However, the IBA will likely continue to publish daily LIBOR rates for several years post-2021, although the form of derivation could be different, the panel of contributing banks could be significantly less and the usefulness of the index rate could be much diminished.

Focusing on U.S. Dollar LIBOR within the United States, the Federal Reserve has tasked the Alternative Reference Rate Committee (ARRC) to be responsible for the transition from U.S. Dollar LIBOR to a new benchmark replacement rate. This replacement rate in the U.S. proposed by the ARRC is a newly created index called the Broad Treasury Financing Rate (BTFR). The BTFR rate contains a broad set of U.S. Treasury market-based financing transactions, also known as repo transactions. Thus far, the BTFR rate appears to be the best replacement for U.S. Dollar LIBOR, although daily volatility of the index will likely need to be smoothed using a geometric average, transaction volume will need to substantially grow, and an actively-traded futures and derivatives market in this new index rate must develop. The Federal Reserve is supposed to begin publishing the BTFR index rates in the first half of 2018. This BTFR rate will have to run in parallel with LIBOR for several years in order to help determine a fair compensating credit spread between LIBOR and BTFR for those financial assets that will need to change their reference interest rate to the new index. Outside of the U.S. Dollar LIBOR solution proposed by the ARRC, we are likely to see multiple differing benchmark replacement rates for LIBOR in non-U.S. dollar LIBOR markets.

Removing and replacing LIBOR is an enormously complicated task. While there are trillions of dollars worth of financial instruments that reference LIBOR, the largest complication rests in those financial assets and those financial contracts that have a maturity beyond the 2021 deadline. As it relates to futures and derivatives contracts, ISDA master agreements between counterparties will have to be amended or replaced. Retail mortgages, home equity lines of credit, and any other consumer or business debt tied to LIBOR will have to be amended unless a back-up interest rate index is referenced in the original documentation. Mortgage-backed securities, loans and floating-rate bonds all tied to LIBOR will have to be addressed contractually, and with regard to deal specific covenants, may require consents from the owners of these securities. In addition, as previously discussed, all of the parties involved will need to come to some consensus that the compensating spread between LIBOR and the BTFR is fair and reflective of the original interest rate and credit risk imbedded within LIBOR.

The current uncertainty surrounding the transition away from LIBOR and the mechanics of that transition are enormous and remain too large to quantify or speculate on any likely impact. We would, however, expect reduced liquidity in LIBOR once the replacement reference rates have been identified globally and gain significant momentum, thereby making LIBOR nearly useless post the transition date despite the potential for LIBOR rates to continue to be published.

There are ultimately three takeaways that are clear during the replacement of LIBOR, both in the U.S. and globally. 1) It will prove to be a herculean task, especially within the five-year window identified by the FCA. 2) We believe the largest complications will come from determining a fair compensating spread and dealing with the legacy securities and contracts that mature beyond 2021 that currently reference LIBOR. 3) The ultimate winner over the next five years or more from the LIBOR transition will be financial and contract lawyers.

Thank you for listening to the Tortoise Credit Strategies podcast and hopefully you will join us for next week’s edition.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseinvest.com.