

Investment News

Monthly Bulletin from the Insurance & Investment Team

September 2017

Last Month in Brief

The Bank of England's Monetary Policy Committee once again voted to keep interest rates at 0.25% with a 6-2 majority, despite inflation remaining at 2.6%, above the Bank's 2% target. The bank predicts this figure could rise above 3% before the end of the year, driven by a weak pound attributed to uncertainty around the ongoing Brexit negotiations. The pound reached an 8-year low of €1.0835 against the euro on August 23rd, before rebounding slightly to €1.0860 the next day. However, Morgan Stanley predicted the overall downward trend to continue and the two currencies reaching parity by the first quarter of 2018, due to ongoing market uncertainty.

In the Eurozone, strong growth figures of 0.6% through the first 6 months of the year has led to speculation that the European Central Bank may soon begin to taper off their quantitative easing program, further strengthening the euro. Growth in France and Spain has exceeded expectations with France witnessing its largest fall in unemployment in 15 years. However, inflation in the region remains sluggish at 1.5% despite overall high confidence and a year-low unemployment rate of 9.1%.

In the US, the direct economic costs of Hurricane Harvey are estimated at anywhere from \$75-160bn. However, impact on markets was more of a mixed bag; damage to oil refineries led to a 4% drop in West Texas Intermediate crude oil prices and may lead to a fall in oil exports in the short term - subsequently dragging down Q3 and Q4 GDP growth by as much as 0.2%.

Chart 1: Equity Indices

Equity markets were stable over the month



Chart 2: Sterling Credit Spreads

Credit spreads were stable over the month

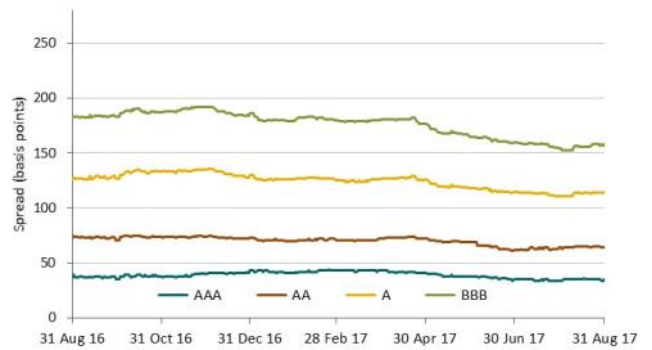


Chart 3: Gilt Yields

Real and nominal gilt yields fell over the month

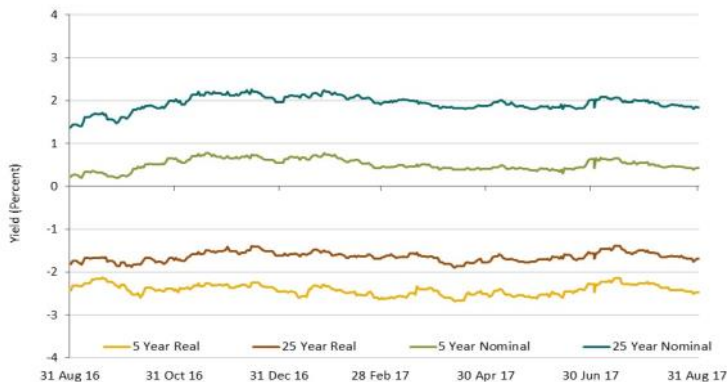
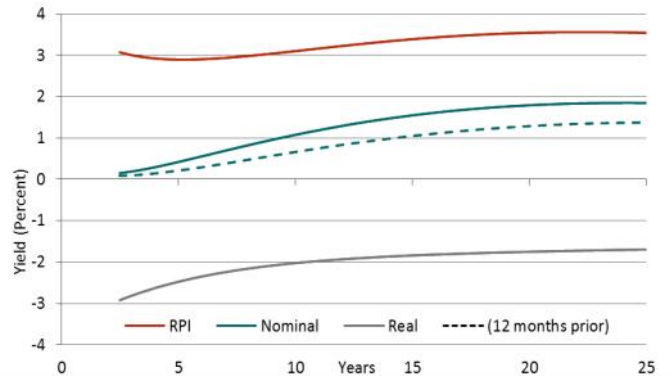


Chart 4: Gilt Spot Curves*

The yield curve remains upward sloping



* Data for the real and inflation gilt spot curves prior to 1st January 2017 is temporarily unavailable from the Bank of England

Source: Bloomberg, Business Insider, MSCI, Merrill Lynch Bank of America and Bank of England.

	Latest	Previous	Latest	Previous
CPI (annual change)	+2.6%	+2.6%	Base rate	0.25%
PPF 7800 funding ratio	89.4%	89.1%	\$/£ exchange rate	1.29
Halifax house prices (monthly change)	1.1%	-0.2%	VIX (volatility) index	10.59
				10.26

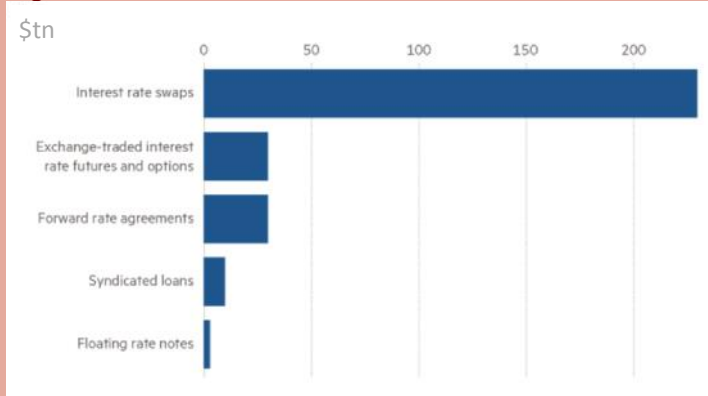
For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

The end of the LIBOR

In July this year, the chief executive of the Financial Conduct Authority (FCA), Andrew Bailey, announced that the sustainability of the London Interbank Offered Rate (LIBOR) in its current form was declining, prompting market participants to discuss whether the time of LIBOR was drawing to a close.

LIBOR is the world's most commonly used benchmark that banks use for short term lending and for short term interest rates. For the past few decades bankers and traders built LIBOR into a range of financial contracts such as corporate loans, see Figure 1. At its peak it was a reference for \$350tn of financial contracts.

Figure 1: Use of LIBOR in financial contracts



Source: The Wheatley Review of LIBOR. Indicative split only as at September 2012.

Since the 2008 financial crisis there has been a sharp fall in the number of financial contracts traded in the market supporting LIBOR, meaning the banks' LIBOR submissions are based on fewer transactions. As a consequence of this fall in activity, the LIBOR benchmark became dependent on judgements made by panel banks, thus subjecting the financial system to a greater vulnerability to manipulation and uncertainty. The LIBOR scandal duly came as it emerged certain banks had manipulated the LIBOR rate, further denting market confidence. To date banks have been fined around \$9bn for their role in rigging the rate.

Due to LIBOR's perceived unsustainability the FCA has announced that LIBOR will be replaced by 2021 in favour of a more transaction-based benchmark.

Possible replacements of LIBOR

According to the FCA, the process of transitioning from LIBOR to another benchmark will take four to five years. It is, however, currently unclear which benchmark rate the FCA will transition to with a number of rates being proposed as viable alternatives.

In the UK, a working group on Sterling Risk-Free Reference Rates at the Bank of England have selected a reformed version of the sterling overnight index average (SONIA) as the preferred replacement benchmark. It is a weighted average of the benchmark rate based on unsecured overnight lending transactions between banks that are greater than £25m. Whilst acknowledging that the UK industry's embrace of SONIA is a key step, Andrew Bailey outlined the criteria

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that a replacement rate would need to satisfy, hinting that SONIA may need to be reformed before it could be adopted.

In the US, the Alternative Reference Rates Committee (ARRC) was also set up to find a replacement rate for LIBOR. ARRC identified a new broad Treasuries repo rate to replace LIBOR, which reflects the cost of borrowing cash secured against US government debt.

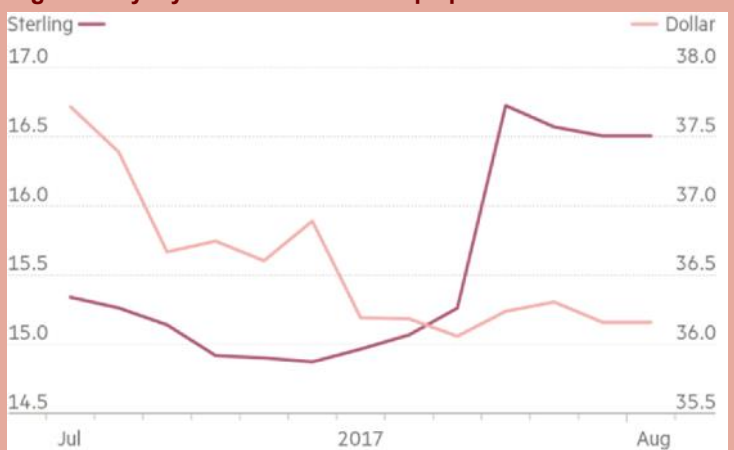
Both SONIA and the new Treasuries repo rate have the advantage that they are based upon actual transaction data rather relying on judgement, so will minimise opportunities for manipulation.

The difficulties in replacing LIBOR

New derivative markets will need to be created which reference the new benchmark rate. The Bank of England is preparing to establish a SONIA futures market and similarly the Chicago Mercantile Exchange is developing derivatives based on the Treasuries repo rate. Such markets will also need appropriate regulatory bodies to be fully established.

The FCA has asked banks to continue submitting to LIBOR until 2021, and has said that there may be a period where more than one benchmark is used. The US Intercontinental Exchange, LIBOR's US administrator, will still be able to publish the dollar rate after 2021.

Figure 2: 5y10y LIBOR indexed swap spreads in UK vs US



Source: Financial Times

Some market participants, especially in the US, believe LIBOR will still be required after 2021. There is currently market uncertainty as participants await for a formal announcement on which alternative rates will be chosen. The lack of increase in spreads on US LIBOR indexed swaps (see Figure 2) may reflect the US market's view that LIBOR may still have a role to play in the future. However, market uncertainty is likely to continue to grow as the market waits to see which new rate is officially chosen to become the heir to LIBOR's former throne.

Previous update on LIBOR

See GAD's [August 2012 update](#) on LIBOR and pension schemes for more information on this topic.

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