Financial Market Analysis

Rising Libor is due to repricing and not distress

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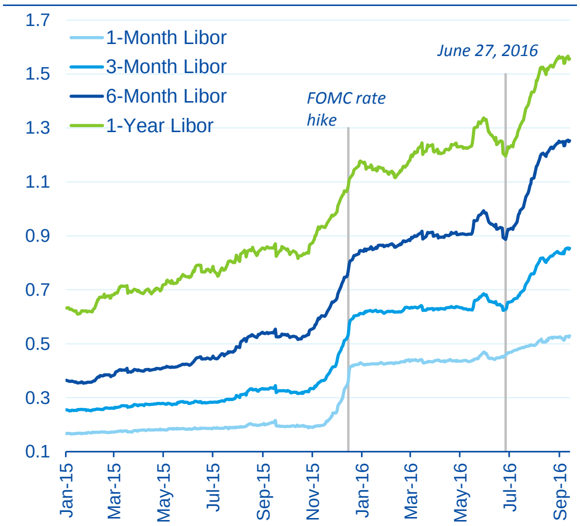
- Libor rate rise pushed by regulation driven structural changes in the U.S. money market
- The spill-over effects in other regions have not been huge. However, hereinafter, international markets have to get used to more expensive financing in USD, which poses an additional risk for bank´s profitability in the current context of ultra-low interest rates.
- Easing in post-reform U.S. dollar Libor rates is dependent upon possible limiting of short-term paper issuance or surfacing of new buyers

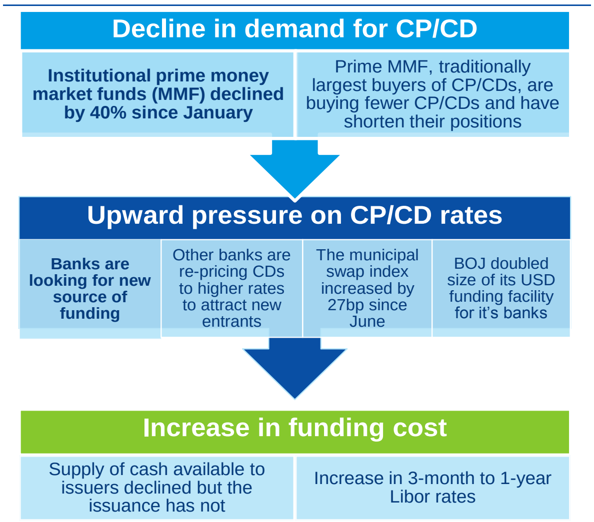
Financial markets have been witnessing a surge in short-term borrowing costs. The 3-month U.S. dollar-denominated Libor rate has been on a steady rise with an overall 23 basis point increase between June 27, 2016 and September 14, 2016. Likewise, the 6-month and 1-year U.S. dollar Libor rates have increased by 37 and 36 basis points respectively. The previous qualitatively similar rise in the 3-month to 1-year Libor rates was driven by the Federal Open Market Committee's decision to increase the Fed Funds rate, while sharp spikes in Libor are usually associated with 2009 financial crisis like environments and clouded confidence in banks' creditworthiness. However, this time around, it is a structural change in the form of regulatory reform in the U.S. money market fund industry[1] that has pushed up the 3-month to 1-year Libor rates yet has left the 1-month rate nearly unchanged with only a 7 basis point increase since June.

Chart 1
U.S. Dollar based Libor (Daily, %)



Source: Haver Analytics, IE and BBVA Research

Table 1
U.S. Money market regulatory reform impact



Source: BBVA Research

[1] The U.S. money market is the financial market segment that is engaged in short-term borrowing, lending buying and selling of assets with maturities of one year or less, and plays a critical financing role in the U.S. economy. The financial transactions include instruments such as treasury bills, commercial paper, certificates of deposit, bills of exchange, repurchase agreements, federal funds, and short-lived mortgage- and asset-backed securities. Money market funds are the major channel of cash management for individuals, businesses, nonprofit organizations, and government agencies.

U.S. market

In 2014, the U.S. Securities and Exchange Commission (SEC) adopted money market fund reform rules that were implemented in stages (see Box 1 for more details on the aim and main characteristics of the reform), while the final and major set of rules will have to be fully implemented by October 14, 2016 and have likely already driven the increase in Libor rates. According to the new money market funds rules, the pricing of institutional primary funds and institutional municipal funds will have to be converted to floating Net Asset Value (NAV) pricing instead of the previous fixed $1 per share NAV method. At the same time, the U.S. Treasury, government, retail prime, and retail municipal money market mutual funds are allowed to remain eligible to be priced using the stable NAV. The implementation of floating NAVs bears its weight on the money market as the fund value has to be updated several times a day. It also affects the precision and timing of trades and the ease of converting funds into liquid assets.

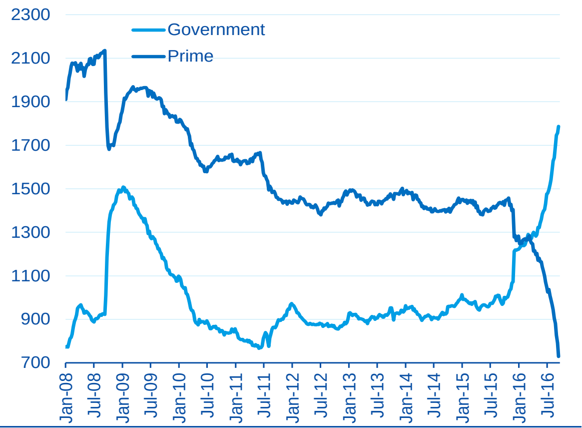
A rebalancing of funds occurred for money market funds in which both institutional and retail prime funds declined by a total of $518 billion, a 37% decline, while total government funds increased by $559 billion since January 2016. The fear of inability to easily redeem holdings from the prime funds, due to the challenges associated with the timings of floating NAV updates and execution of trades, made investors to shift their money from prime into government funds. At the same time, institutional funds are traditionally the largest buyers of bank commercial paper (CP) and certificates of deposit (CDs). As institutional prime fund assets dwindled, the demand for CP/CDs also declined. As the result, the banks have been left searching for new sources of funding, thereby putting upward pressure both on CP and CD rates and on the overall cost of funding. Likewise, the municipal bond market has also been under pressure. The increase in the demand for wholesale funding in the US Libor market is the cause of an increase in Libor rates.

Table 2
U.S. All Money Market Funds
(Weekly total net assets, billions of dollars, %)

YTD Change	Total	Government	Prime
All Money Market Funds	-74.8	559.3	-517.8
Institutional Money Market Funds	12.8	401.3	-349.9
% of All		*72*	*68*
Retail Money Market Funds	-87.6	158.0	-167.9
% of All		*28*	*32*
Since June 27, 2016	**Total**	**Government**	**Prime**
All Money Market Funds	-58.9	310.7	-319.1
Institutional Money Market Funds	-34.5	234.1	-255.4
% of All		*75*	*80*
Retail Money Market Funds	-24.4	76.6	-63.7
% of All		*25*	*20*

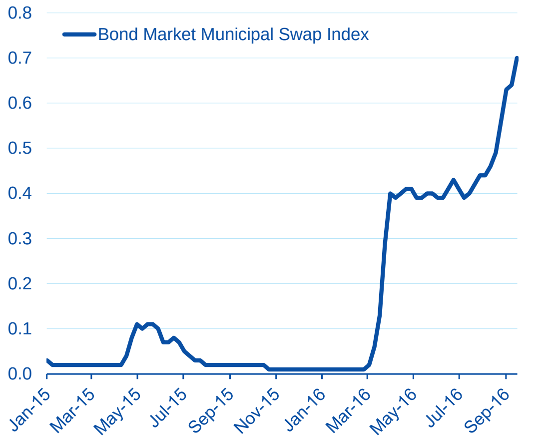
Source: Bloomberg, ICI and BBVA Research

Chart 2
U.S. All Money Market Funds
(Weekly total net assets, billions of dollars)



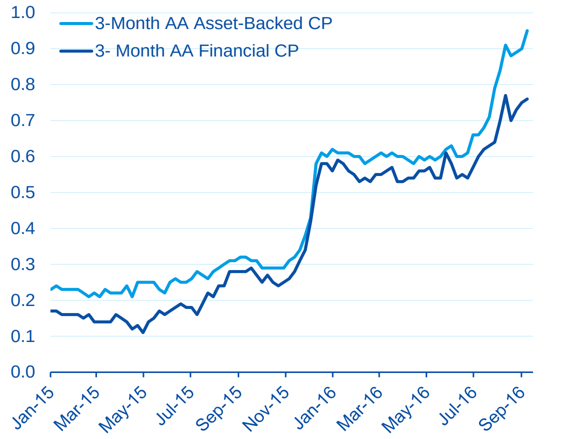
Source: Bloomberg, ICI and BBVA Research

Chart 3
U.S. Municipal Swap Index (Index)



Source: Haver Analytics, BMA and BBVA Research

Chart 4
U.S. Commercial Paper (Average, % per annum)



Source: Haver Analytics, FRB and BBVA Research

Impact in other markets

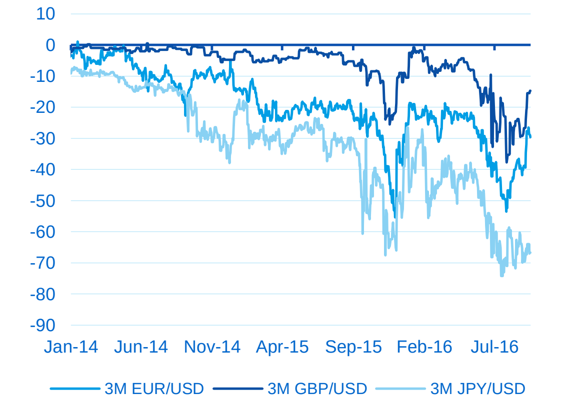
The increase in short term USD funding costs is rekindling fears of it spreading across other regions. The ghost of the Lehman crisis and the possibility a shortage of dollar liquidity in international markets is still there. However, until now, the impact of the upcoming SEC rules in other markets has not been huge, beyond some tightening in cross-currency swaps (mainly in Japan) and depreciation pressures on the RMB. A transitory tightening of funding conditions is expected, as the spike is mainly related with a change in the regulatory environment rather than liquidity risk; however, hereinafter, international markets have to get used to more expensive financing in USD. Nonetheless, another liquidity crisis seems far away, as central banks are coordinated for providing liquidity swap lines if needed in order to help put liquidity into the system and aid in keeping other lending rates low.

Upcoming changes in US money market fund regulations are already having an impact on cross-currency swap markets. Foreign banks that raise funds in their country and swap the proceeds to USD are now handled with higher hedging costs, particularly in Japan. In the euro area and in UK, they rose but eased in summer once Brexit fears faded. In this context, in July, the Bank of Japan decided to support foreign-currency funding by firms and financial institutions: 1) to increase the size of the program for lending US dollars to support growth (from USD12bn to USD24bn (about JPY2.5trn)) and 2) to establish a new program for lending JGB for collateral against USD fund-supplying operations. The reaction to these measures in swap markets was initially positive; however, 3m JPY/USD cross-currency swap spreads remain wider than those in other major currencies.

Besides this impact, US money market fund regulations are adding depreciation pressures on the RMB, which could intensify if the Fed tightens this month and the USD strengthens. The reason is because the Chinese corporate dollar debt is mostly based on the Libor; hence, when the Libor increases, foreign-exchange pressure rises. This encourages companies to pay back their overseas loans, adding pressure to the RMB to weaken. If the Libor remains strong, rising deprecation pressure will tighten funding conditions; so then, the PBOC will have to try to contain capital flows from China to avoid pressure in the Chinese bond market.

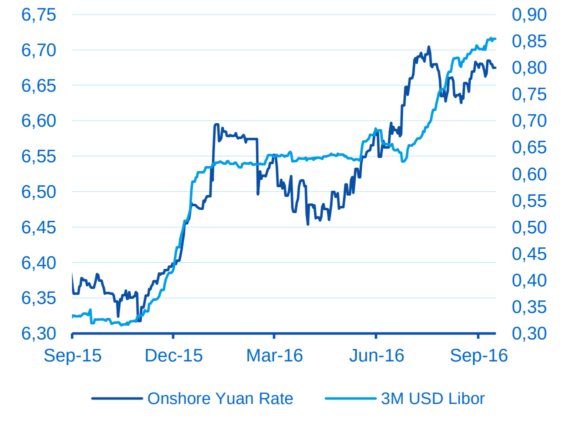
Against this background, beyond some tightening in USD funding conditions and in cross currency swap markets, and in the RMB, the spill-over effects in other regions have been limited. In particular, in the euro area, rates have been unaffected. The 3-month Euribor-OIS spread has remained anchored at very low levels since mid-2012 and in recent months the spread has fallen below 10 basis points. In addition, the ECB still offers USD liquidity, but the demand of US dollar liquidity-providing operations looks very low by euro area banks compared to during the financial crisis. In particular, bank use of the ECB's USD auction, which allows them to borrow as much as they want provided they have collateral, has declined over the past three years as markets have calmed and financial institutions have started lending to each other again. Recent auctions have received bids worth just a few tens of millions of dollars and some saw no bidder at all. In the UK, GBP rates have shown signs of financial stress, experiencing an upward move, but basically reflecting the uncertainty created by Brexit. The 3-month GBP Libor-OIS spread rose by around 16 bps from 15 bps after the Brexit outcome, but since August it has stabilized at around 20 bps (still above pre-Brexit levels).

Chart 5
Cross-currency swap spreads (bps)



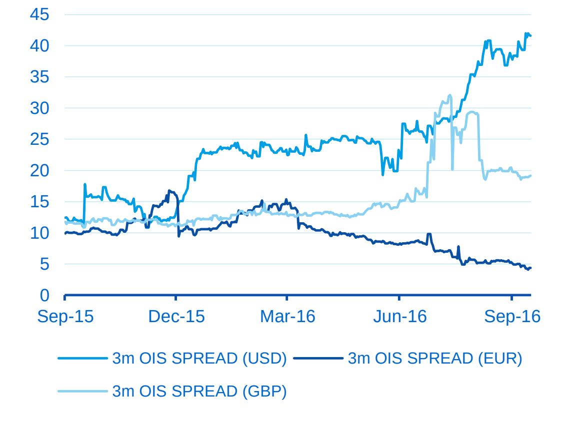
Source: Bloomberg and BBVA Research

Chart 6
3M Libor and Yuan



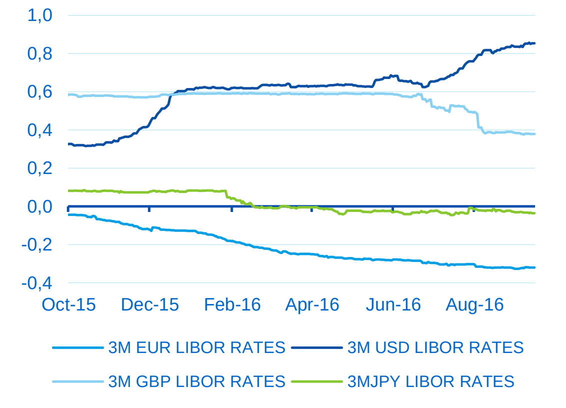
Source: Bloomberg and BBVA Research

Chart 7
3M OIS Spreads (bps)



Source: Bloomberg and BBVA Research

Chart 8
Libor rates (%)



Source: Bloomberg and BBVA Research

What's next?

Libor rates will remain under upward pressure as long as funding availability to U.S. issuers in the credit market remains limited but the issuance of CP and CDs remains unchanged. Thus, Libor rates will depend on when and how the U.S. prime funds stabilize after the new rules go into effect and on whether banks increase or decrease their issuance of CP.

Post-reform, the normalization of Libor rates at lower levels is possible as investors gain confidence in the implementation of floating NAV. Prime funds will restore higher yields relative to government funds and should attract at least partial flow back into prime funds. At the same time, some corporate and individual investors who have immediate liquidity needs and need to access their money throughout the day have likely left prime funds permanently. Furthermore, the upward repricing of short-term debt will be a welcomed opportunity for investors who are in search of yield in the current low to negative yield environment. There will also be an adjustment on the supply side as issuance of CP/CDs has already shown signs of slowing.

International markets have to get used to more expensive financing in USD as this is not a market reaction to a piece of news, is a structural reform that will change the way of how investors allocate their liquidity over time. Certainly, it is a structural change that affects one of the major sources of short-term funding for the banking system. This poses a further threat to profitability at international banks, which are already struggling with negative domestic interest rates (e.g in Japan and in Europe).

Bottom line

The money market reform will bear its cost and shrink the prime-fund space. In the short to medium term, U.S. debt issuers will feel the hardship of a higher Libor and will have to adjust to the structural change in the market. The hardship will be also felt by already debt laden private companies and consumers who borrowed with floating rates, since the leveraged loan market as well as many floating consumer rates, such as mortgages and student loans, are tied to Libor. This can have a tightening effect on the U.S. financial conditions and hurdle economic growth. Additionally, the funds flowing into short-term treasury bills can put downward pressure on the short-end of the treasury yield curve and potentially mute the effect of the Fed's tightening cycle. However, the post-implementation short-term funding cost will likely stabilize and even ease. Over time, repricing of assets and higher prime funds yields relative to government funds will attract new and old short-term debt buyers, thereby catalyzing a partial flow back to prime market funds, which should serve to stabilize funding costs.

The spill-over effects in other regions have not been huge, beyond some tightening in cross-currency swaps (mainly in Japan) and depreciation pressures on the RMB. A transitory tightening of funding conditions is expected, as the spike is mainly related with a change in the regulatory environment rather than liquidity risk. However, hereinafter, international markets have to get used to more expensive financing in USD, which poses an additional risk for bank´s profitability in the current context of ultra-low interest rates.

Box 1

Money Market Reform goes into effect October 14, 2016

Floating Net Asset Value (NAV)

- Institutional prime and municipal money market funds will move from stable NAV ($1.00 price per share) to a floating NAV
- The U.S. Treasury, government, retail prime (general purpose) and retail municipal money market mutual funds will remain eligible to be priced at stable NAV

Fees and Gates

The fund can impose a fee of up to 2% on redemptions if the fund's assets that can be liquidated within one week fall below 30%; a 1% fee if that falls below 10%; or the fund could also prevent redemptions completely for up to 10 days if the 30% threshold is breached

Portfolio Diversification, Disclosure and Stress Testing

- Daily website disclosure of market NAV, liquid assets as a percentage of the total assets, net flows from the previous day

Why

- To address risks of investor runs in money market funds, while preserving the benefits of the fund

Complications

- Calculating and posting up-to-date NAVs for the floating NAV, as pricing should occur multiple times a day. Current industry consensus is to implement three scheduled updates daily
- Ease of access of money in the prime funds is weakened. With the multiple-NAV prime fund there will be a need for more precision in the timing of trade execution as the time needed to process the transaction can be as long as 3 hours. This can be a game changer for liquidity investors who access their funds multiple times per day
- Floating NAV can create gains or losses for the shareholders in these funds and will thus create capital gains tax exposure

Source: SEC and BBVA Research

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