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Client Alert

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International: Boats against the current? Credit-sensitive rates after LIBOR

In brief

Two credit-sensitive USD interest rates have been dealt a severe blow. The International Organization of Securities Commissions (IOSCO) has issued a statement expressing that the administrators of the Bloomberg Short-term Bank Yield Index (BSBY) and Ameribor should refrain from representing that such rates comply with the IOSCO Principles for Financial Benchmarks.

It is too early to tell whether the IOSCO statement tolls the death knell for BSBY, Ameribor and other USD credit-sensitive rates, although it may well inhibit the use of such rates.

The US Adjustable Interest Rate (LIBOR) Act of 2021 ("**US LIBOR Act**") permits US banks to use such rates, even if they do not comply with the IOSCO Principles.

Key takeaways

1. Two credit-sensitive USD interest rates that compete with SOFR in the US loan market have suffered a significant recent setback. IOSCO has issued a statement expressing that the administrators of BSBY and Ameribor should refrain from representing that such rates comply with the IOSCO Principles for Financial Benchmarks.
2. IOSCO's statement may well inhibit the use of BSBY and Ameribor. Market participants look to IOSCO for guidance even though IOSCO is not a regulator and the US does not have a benchmark regime that is similar to the benchmarks regulations in effect in the EU and the UK, which reflect the IOSCO Principles.
3. IOSCO's criticisms of BSBY and Ameribor echo concerns raised by US and UK regulators, such as the following:
    i. The reliance of such rates on the bank commercial paper (CP) and certificate of deposit (CD) markets renders them noncompliant with the IOSCO Principles, because such markets are not deep, robust or reliable enough to underpin these rates as financial benchmarks in compliance with the IOSCO Principles.
    ii. Such rates repeat the "inverted pyramid" problem to which LIBOR was subject.
4. It is too early to tell whether the IOSCO statement tolls the death knell for BSBY, Ameribor and other USD credit-sensitive rates (CSRs). Some lenders have indicated a preference for rates that reflect counterparty credit risk, like BSBY and Ameribor. The US LIBOR Act permits US banks to use such rates, even if they do not comply with the IOSCO Principles for Financial Benchmarks.
5. In addition to regulatory issues, BSBY and Ameribor face competition from SOFR and other products that do not refer to the CP and CD markets.

In depth

IOSCO statement

On 3 July 2023, the first business day following the date of the last USD LIBOR quotes based on panel submissions, IOSCO issued a statement expressing that the administrators of two USD CSRs should refrain from presenting such CSRs as complying with the 2013 IOSCO Principles for Financial Benchmarks ("**IOSCO Principles**").[1] Among other things, IOSCO found that the CP and CD markets that such CSRs refer to were not sufficiently deep, robust or reliable enough to enable the CSRs to comply with the IOSCO Principles.[2] IOSCO urged regulated market participants that were considering using CSRs to contact their relevant regulatory authorities before doing so. Although IOSCO did not specify which CSRs were the subject of the statement, the Financial Stability Board (FSB) indicated in its December 2022 LIBOR transition progress report that IOSCO's review of CSRs related to BSBY and Ameribor.[3]

IOSCO's statement, which was slightly more than two pages, was limited to the conclusions of its review of the CSRs and did not contain the details of its analysis. IOSCO indicated that it had communicated rate-specific findings and recommendations to the relevant administrators. The IOSCO statement also said that it had used SOFR as a comparator for the CSRs.

Although the IOSCO statement did not address USD CSRs other than BSBY and Ameribor, it may call into question the status of other CSRs and stand-alone dynamic credit-adjustment spreads that intend to reflect bank funding costs, such as AXI and FXI, which can be added to SOFR. These products measure bank funding costs, and it is an open question to what extent IOSCO's criticisms of BSBY and Ameribor would apply to such other products to the extent that such other products rely on the same CP and CD markets as BSBY and Ameribor.[4] The SOFR Academy and Invesco Indexing (the developer and administrator of AXI and FXI) issued a joint statement that acknowledged the IOSCO statement and indicated that they looked forward to continuing to provide transparency into how AXI and FXI were constructed, and stated that they were committed to developing and maintaining their indexes in compliance with international standards and requirements.[5]

BSBY/Ameribor response

For their part, the administrators of both BSBY and Ameribor self-certified[6] that these rates were in compliance with the IOSCO Principles.[7] Since the IOSCO statement, the administrator for Ameribor has issued a press release stating that it was "working

[1] IOSCO, Statement on Alternatives to USD Libor. The IOSCO Principles can be found here: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf.

[2] BSBY and Ameribor look to other information as well. BSBY also includes data from bank deposits and trades of unsecured bank corporate bonds. Ameribor is calculated as the transaction-volume-weighted average interest rate of daily transactions in the Ameribor overnight unsecured loan market on the American Financial Exchange.

[3] FSB, Progress Report on LIBOR and Other Benchmarks Transition Issues: Reaching the finishing line of LIBOR transition and securing robust reference rates for the future (fsb.org) §2.3.1 at footnote 23.

[4] Of course, different benchmarks may refer to the same classes of information in different ways, such as by trimming the information in different ways, applying different weightings or measuring the information over different periods.

[5] Invesco Indexing - IOSCO's Statement on Alternatives to USD Libor, 31 July 2023.

[6] The IOSCO Principles contemplate annual self-certification of compliance by benchmark administrators, i.e., "Benchmark Administrators should publicly disclose the extent of their compliance with the Principles annually."

[7] See, for example, American Financial Exchange, Benchmark Interest Rates Reaffirmed To Meet IOSCO Principles For Financial Benchmarks For Fourth Year, 2 May 2022; and BSBY, Management Statement of Adherence with the IOSCO Principles for Financial Benchmarks, as of 14 April 2021. BSBY's administrator engaged Ernst & Young to perform a reasonable assurance examination of the administrator's assertion of BSBY's adherence to the IOSCO Principles. Ameribor's administrator stated that Ameribor's compliance with the IOSCO Principles had been independently reviewed, but did not disclose the firm that had conducted this review.

diligently" to address IOSCO's concerns, and that it was "confident" in its ability to address them.[8] Bloomberg, the administrator for BSBY, indicated that it had "a high degree of confidence in the quality of [its] methodology and calculation."[9]

CSRs controversial

The place of CSRs in the post-LIBOR world has been a matter of controversy for some time. By design, the risk-free rates (RFRs) that have been adopted to replace LIBOR do not reflect counterparty credit risk, while CSRs do reflect such risk. LIBOR was in essence a "cost plus" rate, with LIBOR serving as a proxy for the lender cost of funds.

Although some lenders have expressed a desire for interest rates that reflect counterparty credit risk, regulators have been skeptical of CSRs, and have been concerned that the use of CSRs may reintroduce some of the risks to financial stability that were posed by LIBOR and other interbank rates. In particular, regulators have expressed concerns that CSRs may be subject to the "inverted pyramid" problem to which LIBOR was subject: that rates used in a very large number of transactions are derived from a small number of transactions, rather than the other way around.[10] IOSCO specifically cited this concern in its statement.

In the European zone and Japan, EURIBOR and TIBOR, which are legacy IBORs and therefore incorporate credit sensitivity, have continued to exist after the December 2021 cessation of LIBOR for euro and yen.[11] Rates currently exist in parallel with €STR and TONA, the RFRs developed for those jurisdictions, and are deemed to comply with the IOSCO Principles.

US and UK approaches; lender interest in CSRs

The US and the UK have taken approaches to CSRs that align with the positions taken by their principal regulators, but that differ from each other in other respects.

In the US, some smaller and regional banks in particular have expressed interest in using CSRs. CSRs can allow banks to pass on sharp increases in funding costs that may occur in stressed markets better than static credit adjustment spreads set at the outset of a transaction.[12] A paper[13] authored by several finance professors, including Darrell Duffie of Stanford and the SOFR Academy, found that linking revolving credit facilities to CSRs discourages borrowers from drawing on their credit lines when bank funding costs are high and that, because RFRs typically fall when markets are stressed, borrowers with RFR-linked revolvers would not have a similar disincentive (and may actually be incentivized) to draw on their revolvers. The paper also suggests that the LIBOR transition will have a different effect on smaller banks than it will have on big banks, in that this transition will lead banks with low funding costs to increase spreads by less than banks with higher funding costs.

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[8] See here.

[9] Risk.net, CSRs fight for survival after 'damning' Iosco verdict, 8 August 2023.

[10] See, for example, Remarks by Mr. William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Bank of England's Markets Forum 2018, London, 24 May 2018.

[11] We note that both EURIBOR and TIBOR have been reformed in some respects to better conform to the IOSCO Principles. See, for example, IOSCO, Review of the Implementation of IOSCO's Principles for Financial Benchmarks by Administrators of Euribor, Libor and Tibor, July 2014; and IOSCO, Second Review of the Implementation of IOSCO's Principles for Financial Benchmarks by Administrators of EURIBOR, LIBOR and TIBOR, February 2016. Whether Euroyen TIBOR should cease at the end of December 2024 is now the subject of a public consultation in Japan (Public Consultation on permanent cessation of Euroyen TIBOR and related issues (jbatibor.or.jp)). While there are no current plans to end EURIBOR publication, recent regulatory pronouncements have encouraged EU financial institutions to look more closely at alternatives to EURIBOR, primarily to hardwire fallbacks into their documentation if EURIBOR were to cease.

[12] It is also possible for lenders to invoke the yield protection provisions of their facility agreements to cover when SOFR does not reflect the cost of funding, but this process often requires required lender action and is generally more cumbersome to implement than having the cost be reflected in an index.

[13] Duffie, et al., How the LIBOR Transition Affects the Supply of Revolving Credit, Liberty Street Economics blog, Federal Reserve Bank of New York, February 2023.

Regulatory skepticism of CSRs

Regulators in the US and the UK have expressed their skepticism toward CSRs in different ways. In the UK, regulators have consistently questioned the use of CSRs, with the Financial Conduct Authority (FCA) stating that UK-regulated firms looking to use CSRs should speak to the FCA before doing so.[14] In practice, those warnings have been heeded; no CSRs have been developed for GBP and we are not aware of CSRs for USD being used in the UK.

In the US, several regulators have attempted to discourage the use of CSRs, following some exploration of CSRs in 2020 between the public and private sectors that perhaps suggested more receptivity to the concept.[15] Notably, Gary Gensler, the current chair of the US Securities and Exchange Commission (SEC), has questioned whether BSBY meets the IOSCO Principles,[16] and the federal banking regulators have stated that the use of rates other than SOFR by US-regulated banks will invite deeper regulatory scrutiny.[17]

Following the IOSCO statement, the FSB said that it "welcomes IOSCO's review of [Ameribor and BSBY] and supports and underscores IOSCO's message that 'market participants should proceed with caution if they are considering using CSRs and take into account the risks identified in the review'." The FSB also stated its view that "[u]sing the more recently created 'credit sensitive rates' . . . risks undermining the progress made through the decade-long LIBOR transition."[18]

Protection under US LIBOR Act

On the other hand, the US LIBOR Act, the US federal legislation that provides SOFR fallbacks for US-law-governed tough-legacy USD LIBOR loans, contains language permitting any bank to use a non-SOFR loan benchmark (which would include BSBY and Ameribor) that it determines to be appropriate for its funding model, the needs of its customers, and its products, risk profile, risk management capabilities and operational capabilities. The US LIBOR Act also provides that federal supervisory agencies may not take enforcement and other supervisory actions against banks solely because they use a loan benchmark that is not SOFR.[19] This provision is subject to a proviso that any such use of a loan benchmark must comply with applicable law, which opens the door for US bank regulators to scrutinize non-SOFR benchmarks on the grounds of safety and soundness.[20]

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[14] LIBOR-- 6 months to go, Keynote speech by Edwin Schooling Latter, director of Markets and Wholesale Policy at the FCA, delivered at UK Finance's Commercial Finance Week on 5 July 2021; see also Bank of England, Financial Policy Committee, Financial Stability Report - July 2021. If anything, the position of UK regulators on CSRs has hardened (see FCA, The US dollar LIBOR panel has now ceased, 3 July 2023, where it states: "As we have said previously, we do not want to see transition to so-called 'credit sensitive' rates which have the potential to reintroduce many of the financial stability risks associated with LIBOR.")

[15] The Federal Reserve Bank of New York conducted several credit sensitivity workshops in 2020. Ultimately, the official sector notified the private sector participants (which were representatives of regional banks) that the official sector did not plan to convene a group to recommend a specific credit-sensitive supplement or rate for use in commercial lending products. See Federal Reserve Bank of New York, Transition from LIBOR: Credit Sensitivity Group Workshops, 4 February 2021.

[16] Gary Gensler, Remarks Before the Alternative Reference Rates Committee's SOFR Symposium, 20 September 2021 (specifically addressing BSBY); see also Gensler, Remarks before the Financial Stability Oversight Council: LIBOR, 28 July 2023.

[17] See, for example, Written Testimony of Michael Hsu Before the Senate Committee on Banking, Housing, and Urban Affairs (treas.gov), 3 August 2021. This testimony preceded the enactment of the US LIBOR Act, which (as discussed below) limits in certain respects regulatory actions against banks that use CSRs, but indicates the tone of regulatory skepticism at the time.

Since the passage of the US LIBOR Act, criticism of CSRs by US bank regulators has focused on the safety and soundness of such rates. See, for example, footnote 20, infra.

[18] FSB, Final Reflections on the LIBOR Transition, 28 July 2023.

[19] 12 U.S.C. §5805(b). In addition, the US LIBOR Act provides that it should not be construed to create a negative inference or presumption regarding the validity or enforceability of a non-SOFR benchmark replacement or any modifications to a LIBOR contract that are not "benchmark replacement conforming changes" (as defined in the Act). 12 U.S.C. §5804(e).

[20] For example, a joint statement from the US federal banking regulators cautioned regulated institutions that "safe-and-sound practices include conducting the due diligence necessary to ensure that alternative rate selections are appropriate for the institution's products, risk profile, risk management capabilities, customer and funding needs, and operational capabilities. As part

IOSCO Principles and BMRs

The IOSCO Principles were set forth in 2013 following investigations and enforcement actions concerning the manipulation of LIBOR and other financial benchmarks during the 2007-2009 financial crisis. The EU Benchmarks Regulation[21] and the UK Benchmarks Regulation[22] (BMRs) implement the IOSCO Principles. The US does not have an equivalent benchmark regulation regime. Within the US, the IOSCO Principles are not enforceable by law. Even within the UK and the EU, IOSCO is not itself a regulator, and its view of BSBY and Ameribor does not have regulatory effect; regulators in such jurisdictions would need to act if and when the administrators of such CSRs took steps for such benchmarks to be used in such jurisdictions. That said, the IOSCO statement will likely carry considerable weight with UK and EU regulators.

The IOSCO statement implicitly recognized its lack of regulatory effect by noting that it was aware that "CSRs may continue to be offered and used going forward, despite the conclusions of this Review." However, the statement warns that "market participants should proceed with caution if they are considering using CSRs and take into account the risks identified in the Review."

The BSBY webpage indicates that it may not be used in the UK,[23] but that it is available for use in the EU under the third-country regime under the EU BMR.[24] The AXI and FXI webpage indicates that they may not be used in the UK or the EU.[25] The SOFR Academy is in the process of developing the EUR AXI, which would be added to €STR, and will likely seek to make EUR AXI comply with the EU BMR.[26]

Despite its lack of regulatory effect, the IOSCO statement was obviously intended to dissuade lenders and borrowers from using BSBY and Ameribor, and may succeed in doing so. IOSCO has noted that many benchmark users place great stock in whether benchmarks comply with the IOSCO Principles, and IOSCO's view that the CSRs are not compliant may cause certain market participants to choose alternatives that do comply.

IOSCO criticisms of BSBY and Ameribor

In 2021, IOSCO issued a statement on CSRs that reflected the concerns that regulators had expressed regarding CSRs.[27] This statement called on CSR benchmark administrators to assess, in accordance with Principles 6 and 7 of the IOSCO Principles, whether the CSRs were based on active markets with high volumes of transactions, representing the underlying interest they intended to measure, and whether such benchmarks were resilient during times of stress. IOSCO's call to examine whether CSRs were resilient during times of stress echoed criticisms made by US and UK regulators, which noted that CSRs were in large part derived from the CP and CD markets, which the regulators asserted had not been resilient during the onset of the COVID-19 pandemic in March 2020.[28]

In its July 2023 statement, IOSCO said that its review of Ameribor and BSBY had concluded that, due to liquidity risks in the CP and CD markets, such markets were not sufficiently deep, robust or reliable enough to underpin the CSRs as financial benchmarks in compliance with the IOSCO Principles. IOSCO found that bank funding in those markets was at low volumes during normal

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of their due diligence, institutions should understand how their chosen reference rate is constructed and be aware of any fragilities associated with that rate and the markets that underlie it." Joint Statement on Completing the LIBOR Transition, 26 April 2023.

[21] Regulation (EU) 2016/101.

[22] As part of the Brexit process, the EU BMR was "on-shored" to the UK in 2020 to become the UK BMR.

[23] See BSBY-Web-Terms.pdf (bbhub.io). As of 25 October 2021, BSBY's webpage indicated that the administrator expected BSBY to be made available in the UK under the UK BMR (see footnote 24, infra).

[24] See BSBY-Fact-Sheet_231025.pdf (bbhub.io).

[25] See IIS: Integrated tearsheets (invescosofracademyaxi.com).

[26] See European AXI - SOFR Academy.

[27] IOSCO, Statement on Credit Sensitive Rates, 8 September 2021.

[28] See speeches cited at footnotes 14 and 16, supra.

conditions, and that such volumes were lower still during periods of market stress.[29] IOSCO also said that its review indicated that the CSRs' reliance on a very small number of transactions in those markets resulted in volatility and gaps in data, which IOSCO asserted meant that the CSRs, as currently constructed, were unlikely to sufficiently implement the IOSCO Principles relating to benchmark design.

IOSCO found that the low transaction volumes in the CP and CD markets might cause CSRs to deviate from rates that were available to market participants. IOSCO found that this potential deviation, coupled with such rates' use of executable quotes, might also increase the risk of manipulation.[30]

In all, IOSCO stated that its review confirmed the view of regulatory authorities that the CSRs "exhibit some of the same inherent 'inverted pyramid' weaknesses as LIBOR. Absent modification, their use may threaten market integrity and financial stability" (footnote omitted).

In its statement, IOSCO included general recommendations for the CSR administrators, such as the following: (1) consider and clearly disclose how they have considered the "concept of proportionality"[31] in assessing compliance with the IOSCO Principles; (2) consider licensing restrictions in accordance with recommendations from the ARRC, the UK national working group and regulators; and (3) consider improving the transparency of their rates, including through publishing samples of input data, methodology and calculation (adjusted as necessary to protect proprietary methodology), to allow end users to replicate published rates.

Death knell for BSBY and Ameribor? Too early to say

It is likely too early to tell whether the IOSCO statement tolls the death knell for BSBY and Ameribor, but it clearly puts them in some peril.[32] The administrators of BSBY and Ameribor may succeed in modifying those CSRs to IOSCO's satisfaction so that IOSCO removes its objections.

The administrators of BSBY and Ameribor have criticized the IOSCO statement, as have others.[33] John Shay, the CEO of American Financial Exchange, Ameribor's administrator, disagreed that Ameribor had an "inverted pyramid" issue, arguing that Ameribor occupied a much smaller market than SOFR.[34] Whatever merit these criticisms may have, they seem unlikely to persuade IOSCO to change its mind, and also unlikely to lead end-users to disregard IOSCO's view.

Shay also indicated a determination to continue even if IOSCO were to continue to declare Ameribor noncompliant with the IOSCO Principles, even though the use of the rate in this case might be limited to smaller and regional banks, and to the US only.[35]

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[29] For its part, the administrator of BSBY issued a report in July 2023 in which it asserted that the volume of underlying transactions supporting BSBY had been robust since BSBY's inception in 2022, including during the banking crisis in March 2023. See Bloomberg-BSBY-Bulletin_July-2023.pdf (bbhub.io).

[30] It may be possible for the CSRs to safeguard against manipulation in their methodologies. For example, the BSBY methodology uses anonymized quotes and trims the top and bottom 25% of input data. The BSBY methodology also caps any one bank's contribution to the data at 20%. The BSBY information is also not submitted by banks, but is gathered by BSBY from other sources.

[31] The concept of "proportionality" is embedded in the IOSCO Principles, and means, with particular relevance in the context of LIBOR replacements, that the more widely a benchmark is used, the more robust it needs to be. See, for example, IOSCO Principles, chapter 1, where it states: "The application of these Principles should be proportional to the size and risks posed by each Benchmark and/or Administrator and the Benchmark-setting process."

[32] See Risk.net, Iosco deals hammer blow to BSBY, Ameribor, 4 July 2023.

[33] Risk.net, CSRs fight for survival after 'damning' Iosco verdict, 8 August 2023. Among the criticisms raised are the following: (i) the lack of detailed analysis in the IOSCO statement makes it difficult to assess when an "inverted pyramid" would exist and when one would not; (ii) IOSCO may not be applying the IOSCO Principles consistently to the USD CSRs, on the one hand, and to EURIBOR and TIBOR, the legacy non-USD CSRs, on the other, particularly when EURIBOR and TIBOR may have similar "inverted pyramid" issues; (iii) the general recommendation as to sample data was not something that was required of other benchmarks, including SOFR; and (iv) comparing the CSRs to overnight SOFR may not be appropriate, since the goals and target market of the CSRs are different from those of SOFR. Id.

[34] Id.

[35] Risk.net, Iosco criticism dents AFX's plans for Ameribor derivatives, 13 July 2023.

Despite all the skepticism of CSRs from regulators in the US and elsewhere, the US LIBOR Act's express permission for US-regulated banks to use non-SOFR rates may mean that, in the US anyway, BSBY and Ameribor are not simply boats beating on against a powerful regulatory current, although such description may be more fitting in non-US markets. However, the space available to them in the market is not clear,[36] particularly since noncompliance with the IOSCO Principles may dissuade end users, despite the rates remaining technically available under the US LIBOR Act.

For all the regulatory hurdles that CSRs face, the most significant issue may be market competition from non-CSR rates, the RFRs; in the US in particular, the 2021 recommendation by the US Alternate Reference Rates Committee (ARRC) of Term SOFR for loan products has made available an attractive forward-looking RFR variant.[37] As noted by Tom Wipf, the former chair of the ARRC, while CSRs may be attractive to banks, it is not clear why they would be attractive to borrowers.[38] If a borrower is offered an RFR facility with a static credit spread adjustment by one bank, and a CSR facility or an RFR facility with a dynamic credit spread adjustment by another bank, the borrower may choose the RFR facility with the static adjustment to avoid the risk of increased costs in a stressed market. This may provide a competitive advantage to bigger banks with more diversified funding sources that are more willing to provide RFR facilities to borrowers.

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[36] Ameribor's use in syndicated facilities appears minute, while its use in bilateral facilities is difficult to track. According to BSBY Watch, there are currently 172 syndicated BSBY facilities with over USD 24 billion in commitments. It is also difficult to track BSBY's use in bilateral facilities. For some context on the size of the US syndicated facilities market, the OCC's 2022 Shared National Credit (SNC) Report stated that the size of the US SNC market was USD 5.9 trillion for the period covered by the report.

[37] The IOSCO statement indicated that it had also reviewed Term SOFR. IOSCO stated that Term SOFR was "suitable for limited use only" in accordance with the use case set forth by the ARRC (e.g., in cash products, with limited hedging of cash products).

[38] Risk.net, ARRC's Wipf 'puzzled' by appeal of Libor-like benchmarks, 28 April 2021.

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