IOSCO STATEMENT

International Organization of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valores
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المنظمة الدولية لهيئات الأوراق المالية

THE BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

Statement on Credit Sensitive Rates

8 September 2021

The Board of the International Organisation of Securities Commissions (IOSCO) reiterates the importance of continued transition to robust alternative financial benchmarks, *i.e.*, Risk-Free Rates, to mitigate potential risks arising from the cessation of LIBOR, including USD LIBOR.

IOSCO wishes to highlight those alternative financial benchmarks will need to be compliant with the IOSCO Principles on Financial Benchmarks (IOSCO Principles). Benchmark administrators should be mindful that demonstrating compliance with the IOSCO Principles is not a one-time exercise and alternative benchmarks should be IOSCO compliant at all times.

In light of some alternatives being suggested, notably *credit sensitive rates,*[1] IOSCO calls for greater attention to Principles 6 and 7. Principle 6 asks administrators to take into account the *'relative size of the underlying market in relation to the volume of trading'*. Principle 7 emphasises *'data sufficiency in a benchmark's design to accurately and reliably represent the underlying market'* measured by the benchmark. Therefore, in line with Principles 6 and 7, IOSCO calls on administrators to assess whether the systemic benchmarks that are used extensively are based on active markets with high volumes of transactions, representing the underlying interest they intend to measure and whether such benchmarks are resilient during times of stress.

Regulators are concerned that some of LIBOR's shortcomings may be replicated through the use of credit sensitive rates that lack sufficient underlying transaction volumes. The disproportionality between the low/modest volume of transactions underlying credit sensitive rates and the increasingly higher volumes of activity in markets referencing them - the so-called *inverted pyramid problem* - raises concerns about market integrity, conduct risks and financial stability risks. The decline in the underlying activity of some of the credit sensitive rates during stress periods, such as the COVID-19 pandemic, raises additional regulatory concern.

[1] Credit sensitive rates are interest rate benchmarks that seek to measure the credit risk component of unsecured borrowing in certain markets (which SOFR does not contain). These rates have started to emerge as a possible alternative to USD LIBOR.

Therefore, Benchmark administrators of credit sensitive rates should consider how their benchmarks would continue to meet Principles 6 and 7 over time if use of that benchmark became widespread. Some of these rates are based on similar markets to LIBOR and may replicate many of LIBOR's shortcomings, as highlighted by authorities in the US and UK. Users of benchmarks should also consider the robustness and reliability of the benchmarks they choose and ensure that they have reliable fallback mechanisms that can be used, should their chosen benchmarks cease or become unrepresentative.

IOSCO supports the Financial Stability Board's recent remarks that '*to ensure financial stability, benchmarks which are used extensively must be especially robust*'. Widespread use of and transition to credit sensitive rates, instead of the US Alternative Reference Rates Committee's preferred Secured Overnight Financing Rate (SOFR), may therefore pose risks to financial stability. The IOSCO Board notes that SOFR provides a robust rate suitable for use in most products, with underlying transaction volumes that are unmatched by other alternatives.

Users of benchmarks place considerable value on a benchmark being IOSCO compliant. To continue to give market confidence in the reliability and integrity of financial benchmarks, IOSCO will be monitoring closely how the IOSCO badge is used in compliance assessments of the relevant credit sensitive rates.

"*The sound functioning of systemically important benchmarks is vital to the global economy and financial markets. Therefore, it is crucial that potential alternative rates to LIBOR are especially robust and reflect credible underlying markets underpinned by a sufficient volume of transactions to avoid the problems we have experienced with LIBOR. In light of the recent regulatory concerns about the insufficient activity in markets underlying certain credit sensitive rates, compliance with the IOSCO Benchmark Principles at all times is fundamentally important. IOSCO will closely watch market developments in this respect.*" said Ashley Alder, the Chief Executive Officer of the Securities and Futures Commission of Hong Kong and the IOSCO Board Chair.

Responding to the IOSCO statement, Andrew Bailey, Governor of the Bank of England and Co-Chair of the Financial Stability Board's Official Sector Steering Group, said: "*Today's statement by IOSCO further highlights the importance of using robust benchmarks when moving away from LIBOR. Markets should not risk the progress we've made by using supposedly credit sensitive rates that do not address LIBOR's fundamental weaknesses. These rates may well fail to comply with IOSCO Principles if their use became widespread. We need to learn the lessons of LIBOR, and ensure we transition to lasting solutions. I welcome IOSCO's commitment to monitor the ongoing compliance of financial benchmarks, including credit sensitive rates, with its Principles*."

John C. Williams, President of the Federal Reserve Bank of New York and Co-Chair of the Financial Stability Board's Official Sector Steering Group, added: "*Compliance with all of the IOSCO Principles—consistently over time—is essential to a successful and lasting transition from LIBOR. With this in mind, market participants should now be moving to robust reference rates like SOFR to avoid jeopardizing financial stability*."