IOSCO STATEMENT

International Organization of Securities Commissions
Organisation internationale des commissions de valeurs
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المنظمة الدولية لهيئات الأوراق المالية

THE BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

Statement on Alternatives to USD Libor

3 July 2023

The Board of the International Organization of Securities Commissions (IOSCO) has concluded its *Review of Alternatives to USD Libor* (Review), which assessed the extent to which four benchmarks developed as potential substitutes for USD LIBOR – two credit sensitive rates (CSRs) and two Term SOFR rates – have implemented IOSCO's 2013 Principles for Financial Benchmarks (IOSCO Principles) in the areas of benchmark design (Principle 6), data sufficiency (Principle 7) and transparency (Principle 9). IOSCO used the Federal Reserve Bank of New York-administered Secured Overnight Financing Rate (SOFR[1]) as a comparator. IOSCO identified varying degrees of vulnerability of concern with each rate's implementation of the Principles in scope, as compared to SOFR, along with areas for improvement.

Most significantly, the review confirmed regulatory authorities' concerns that certain CSRs currently in use exhibit some of the same inherent "inverted pyramid" weaknesses as LIBOR.[2] Absent modification, their use may threaten market integrity and financial stability. For instance, the Review concluded that due to liquidity risks in the bank-issued commercial paper (CP) and certificates of deposit (CD) market data, they are not sufficiently deep, robust and reliable to underpin alternatives to USD LIBOR. Further, gaps in data and volatility related to reliance on a very small number of transactions mean that USD LIBOR alternatives based on these markets are unlikely to sufficiently implement the IOSCO's Principles relating to benchmark design.[3] Structural issues with bank-issued CP and CD markets stem from changes in the way banks fund their operations leading to low volumes with heterogeneous rates during normal conditions. During

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1 Alternative Reference Rates Committee (ARRC) recommended USD LIBOR replacement rate.

2 The inverted pyramid problem refers to the disproportionality between the low/modest volume of transactions underlying CSRs and the increasingly higher volumes of activity in markets referencing them. This raises concerns about market integrity, conduct risks and financial stability risks and can make a benchmark vulnerable to manipulation.

3 Principles 6 provides that a benchmark design factors should include (but are not limited to) Size and liquidity of the relevant market; Relative size of the underlying market in relation to the volume of trading in the market that references the Benchmark; Market dynamics and more.

stressed conditions, market liquidity tends to decline further. Low transaction volumes, coupled with the use of quotations, could not only cause deviation from rates that might be available to participants in the markets if they chose to transact, but can also increase the risk of benchmark manipulation.

The Term SOFR rates reviewed were somewhat better placed among the rates reviewed, but still fell short of SOFR. IOSCO believes that the Term SOFR rates are suitable for limited use only, as already highlighted by the FSB and National Working Groups[4] and Regulators. Term SOFR rates are different from SOFR because Term SOFR rates are based on derivative market transactions, and they rely on the continued existence of a deep and liquid derivatives market based on overnight SOFR.[5] The use of Term SOFR rates in derivatives markets should remain limited so that these rates can remain sustainably available for more limited appropriate use cases. If reference to Term SOFR rates were to become too widespread, at the expense of trading in the underlying SOFR derivatives (i.e., futures or swaps) markets, it would undermine the Term SOFR rates themselves.

IOSCO has communicated its rate-specific findings and recommendations to the relevant administrators. For all administrators, IOSCO recommends that:

- Administrators should consider and clearly disclose how they have considered applying the "concept of proportionality" in assessing compliance with the IOSCO Principles.

- Administrators should consider licensing restrictions for use of CSRs and Term SOFR rates within certain products or by certain user groups, in line with recommendations from National Working Groups where relevant, to the extent that similar restrictions would be appropriate for their rates as a way to prevent widespread usage which would be disproportionate to the underlying markets a benchmark seeks to measure.

- Administrators should consider whether to improve the transparency of their rates, either through their methodology documentation or by making underlying statistical data more readily available. Generally, IOSCO believes that the highest standard of transparency would require administrators to publish samples of input data, methodology and calculation such that users can replicate published rates. Some of this input data or details of the methodology could be proprietary, so administrators should decide how to best share this information.

- Based on the findings of this Review, Administrators, as well as their auditors and independent consultants, should refrain from any representation that the CSRs reviewed are "IOSCO-compliant".

IOSCO notes that some market participants (primarily in the US markets) have referenced CSRs in contracts, particularly in certain lending products, and that CSRs may continue to be offered

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4 Unites States' Alternative Reference Rates Committee (ARRC) and United Kingdom's Working Group on Sterling Risk-Free Reference Rates (RFRWG).

5 SOFR is a fully transactions-based rate underpinned by a daily average of roughly US $1 trillion in transaction volume based on thousands of transactions. Source: https://www.fsb.org/wp-content/uploads/P161222.pdf

and used going forward, despite the conclusions of this Review. IOSCO emphasizes market participants should proceed with caution if they are considering using CSRs and take into account the risks identified in the Review. IOSCO also urges regulated market participants considering using CSRs to contact their relevant authorities before doing so.[6]

[6] The UK FCA has previously urged UK regulated firms to contact the Authority before referencing CRSs within their contracts.